REVENUE ACT OF 1962

1498—

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

EIGHTY-SEVENTH CONGRESS

SECOND SESSION

ON

H.R. 10650

AN ACT TO AMEND THE REVENUE ACT OF 1954 TO PROVIDE A CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY, TO ELIMINATE CERTAIN DEFECTS AND INEQUITIES, AND FOR OTHER PURPOSES

APRIL 2, 1962

PART 1

Printed for the use of the Committee on Finance

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REVENUE ACT OF 1962

MONDAY, APRIL 2, 1962

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:15 a.m., in room 2110, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd (chairman), Kerr, Anderson, Douglas, Gore, McCarthy, Fulbright, Williams, and Carlson.

Elizabeth B. Springer, chief clerk; and Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. I may say that the House Ways and Means Committee worked on this bill for 10 months. I am not predicting that the Senate Finance Committee will work 10 months but we are certainly going to give it a very thorough look.

There are 240 pages in the bill. The House committee report covers 303 pages. More than 200 witnesses have already indicated that they would like to be heard by the Finance Committee before the bill is reported. It appears that our hearings will require more than a month. At least this must be regarded as a major tax bill.

(The summary and bill follow:)

SUMMARY OF H.R. 10650, THE REVENUE ACT OF 1962

(As Passed by the House of Representatives on March 29, 1962)

Section

1 *Short title, etc.*—The act is to be cited as the "Revenue Act of 1962."

2 *Investment credit.*—Under the House-passed bill an investment credit against tax liability is provided. It generally is 7 percent (3 percent in the case of certain public utilities) of investments in new tangible personal property and most other depreciable real property except buildings and structural components of buildings. No credit is allowed for property with a useful life of less than 4 years. For property with a life of 4 to 6 years, one-third of the investment is taken into account; for property of 6 to 8 years, two-thirds is taken into account; and for property with longer lives, the full amount of the investment is taken into account. Purchases of used property, up to $50,000 worth, also is eligible for the credit. The credit may offset tax liability in full up to $25,000, but above that point the credit may not reduce tax liability by

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more than 25 percent. Any unused credit may be carried over for 5 years and used in those years to the extent there is sufficient tax liability under the applicable limitation. This provision is effective for taxable years ending after December 31, 1961, but only with respect to property acquired or to the extent constructed, reconstructed, or erected after that date.

3 *Appearances with respect to legislation.*—A deduction is provided for costs relating to appearances before, presentation of statements to, or communications sent to a legislative body, a legislative committee, or individual legislator (Federal, State, or local), if the expenses are otherwise ordinary and necessary business expenses. A deduction also is allowed for the portion of dues paid to an organization which are used for similar legislative expenses to the extent they are related to the businesses of its members. In addition, the expense of communication of information between the taxpayer and the organization with respect to legislation is deductible. This provision does not permit the deduction of expenses incurred for attempts to influence the general public, or segments of the public (by advertising or otherwise), or for expenses concerned with political campaigns. This provision applies to taxable years beginning after December 31, 1962.

4 *Entertainment expenses.*—Deductible expenses for entertainment, amusement, or recreation generally are limited to those directly related to the active conduct of a trade or business and, in the case of facilities, a further restriction is imposed to the effect that the facility must be used more than 50 percent for the furtherance of the taxpayer's trade or business. Club dues are treated the same as facilities. An exception to this limitation is provided for business meals where the surroundings are such as to be conducive to a business discussion. Eight other specific exceptions also are provided.

A second feature of the provision limits the deduction for business gifts to $25 per year per individual recipient. In a third feature of the provision, rules are set forth providing that the deduction of entertainment or travel expenses will be denied unless they are substantiated (by adequate records, etc.) as to amount, time and place, business purpose, and business relationship to the taxpayer of the persons involved. Fourth, in the case of traveling expenses, only a "reasonable" allowance for amounts spent for meals and lodging is to be deductible rather than the "entire" amount so spent.

This provision applies to taxable years ending after June 30, 1962, for periods after that date.

5 *Distributions in kind by a foreign corporation.*—Distributions in kind from foreign corporations to domestic corporations are treated as having a value equal to the fair market value of the property distributed (and not the adjusted basis of this property in the hands of the distributing corporation where this is lower). This applies to distributions made after December 31, 1962.

6 *Allocation of income in the case of sales to or from a foreign corporation.*—Where goods are sold by a domestic corporation

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to a related foreign corporation, or vice versa, the taxable income arising from these transactions is to be allocated between the parties on the basis of the location of the assets used in the operations, the payroll attributable to them, and the related selling expenses. Other factors may also be taken into account. This rule is not to apply where an arm's length price can be established by the taxpayer for the purchases or sales. Sales commissions of a related corporation are to be treated under similar rules. This is effective for taxable years beginning after December 31, 1962.

7 *Foreign personal holding companies.*—At present, the entire income of a foreign personal holding company is taxed to the U.S. shareholders if 60 percent (50 percent after the first year) or more of its income is from passive sources (such as interest, royalties, and dividends). The bill provides that if 20 percent or more of the income is from these passive sources, then the passive portion of the income is to be taxed to the U.S. shareholders and if more than 80 percent of the income is from these passive sources, then the entire income is to be taxed to the U.S. shareholders (to the extent of their holdings). This applies to taxable years beginning after December 31, 1962.

8 *Mutual savings banks, etc.*—Mutual savings banks, domestic building and loan associations, and cooperative banks under present law are allowed to add all of their income to bad debt reserves until reserves reach 12 percent of deposits. In lieu of this, they are to be permitted deductions for additions to bad debt reserves generally of up to 60 percent of their taxable income (before this deduction) or, if larger, an amount bringing their reserves up to 3 percent of improved real property loans, plus a reasonable addition for other loans. (Existing reserves in excess of this amount are disregarded.) The bill also provides that the reserves may be accumulated in excess of 3 percent of these loans if the taxpayer's experience shows this is required.

Under the House-passed bill in the case of stock savings and loan associations, distributions to shareholders will be considered as paid first out of already tax-paid funds and, only when these are exhausted, out of reserve funds on which a tax has to be paid by the association at the time of distribution. Also, under the bill, a domestic building and loan association is defined as one which is insured under the National Housing Act or subject to State or Federal supervision but only if substantially all of its business consists of accepting savings and investing the loans in residential real property or in loans authorized for a Federal savings and loan association under section 5(c) of the Home Owners Loan Act. In addition, the exemption for Federal savings and loan associations from the excise taxes on communications and transportation of persons is repealed.

Generally, these provisions are effective for taxable years ending after December 31, 1962. The excise tax changes, however, are effective as of June 30, 1962.

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9 *Distributions by foreign trusts.*—Distributions by foreign trusts established by U.S. grantors (or added to by U.S. transferors) are to be taxed to any U.S. beneficiaries in substantially the same manner as if the beneficiaries had received this income directly in the year earned rather than later when the distribution is made. However, the additional tax is payable at the time of the actual distribution. For those preferring not to make the calculations required under this "exact method" of taxation, an averaging device is provided. This applies to distributions, (accumulated after the effective date of the 1954 Code) made in taxable years beginning after the date of enactment of the bill.

10 *Mutual fire and casualty insurance companies.*—Mutual fire and casualty insurance companies are to be taxed on their "total" income less a deduction for additions to a reserve for protection against losses equal to one-fourth of their underwriting gains plus 1 percent of their insurance claims. After a 5-year interval, the 1 percent set-aside with respect to insurance claims and one-half of the amount attributable to underwriting gains is brought back into the taxable income to the extent not already offset by losses. The remainder, to the extent not offset by losses, will remain in the loss reserve but no amount may be added to this reserve which would build it up to a level of more than 10 percent of the current year's premiums.

Companies whose total receipts do not exceed $75,000 are to remain exempt from tax, and companies with total receipts of between $75,000 and $300,000 are to be taxed only on their investment income. For those with gross receipts above $300,000, a special deduction of $6,000 is provided which decreases as gross receipts rise and disappears at a level of gross receipts of $900,000. Factory mutual companies are to be taxed like stock companies without the special reserve referred to above. However, in computing their underwriting profits they will be permitted to determine their premium income on the basis of "absorbed" premium deposits (i.e., in general, excluding the portion of the deposit returnable to the person insured). The amount so determined is then increased by 2 percent. Reciprocal underwriters and interinsurers are in effect permitted to combine the underwriting income of their corporate attorney-in-fact with their own for purposes of offsetting losses but not for purposes of computing the underwriting income addition to their loss reserve.

These provisions apply to taxable years beginning after December 31, 1962.

11 *Domestic corporations receiving dividends from foreign corporations.*—Under present law when the income of a foreign subsidiary is distributed to a domestic parent corporation only the income of the subsidiary remaining after tax is treated as a dividend and a foreign tax credit is allowed the parent corporation for that part of the foreign taxes paid by the subsidiary attributable to this income. Under the bill the amount included in the tax base of the domestic corporation, if it elects

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the foreign tax credit, is to be not only the dividend itself but also the tax paid by the foreign corporation as well and then the full amount of the taxes paid by the foreign corporation may be allowed as a credit.

Also, where a foreign corporation is eligible for the 85 percent intercorporate dividends received deduction with respect to income earned in the United States, the 15 percent of this income for which no deduction is allowed is not to be treated as foreign source income for purposes of the foreign tax credit. The subsection of present law making the foreign tax credit available for royalty income received from wholly owned subsidiaries in certain cases is repealed.

These amendments become fully effective for distributions received by domestic corporations after December 31, 1964. In the case of distributions received by domestic corporations before 1965 but in taxable years after December 31, 1962, the new rules are to apply in the case of distributions made out of profits of a foreign corporation accumulated in taxable years beginning after December 31, 1962.

12 *Earned income from sources outside the United States.*—Under existing law individuals who are present in a foreign country or countries for 17 out of 18 months may exclude from their U.S. tax base up to $20,000 per year of income earned abroad. If they are bona fide residents of a foreign country there is no ceiling on this exclusion. In the case of these bona fide foreign residents, a ceiling is to be provided of $20,000 for the first 3 years they are abroad and $35,000 thereafter. In addition, contributions made by employers for employee benefits under qualified pension plans with respect to future employment are to be taxable to the employee when he receives these amounts after retirement. Generally these provisions are effective with respect to taxable years ending after December 31, 1962.

13 *Controlled foreign corporations.*—In the case of controlled foreign corporations, where more than 50 percent of the stock is owned by U.S. persons, U.S. shareholders who own 10 percent or more of the stock in these corporations are to report for tax purposes the undistributed earnings of these corporations to the extent they represent (*a*) income from insuring or reinsuring U.S. risks; (*b*) income from patents, copyrights, and exclusive formulas or processes developed in the United States or acquired here from related persons; (*c*) passive types of income; and (*d*) income from purchases or sales with related persons where the goods are produced or grown and the property is sold for use outside of the country of incorporation of the foreign corporation involved. In these latter two cases, the combination of the two types of income must equal 20 percent of total income before it is taken into account (and sales income must equal 20 percent of income other than the passive income to be taken into account). Where this combined income equals more than 80 percent of the total, then all income is attributed to the shareholders. However, reductions in the income taxed to shareholders are allowed in these two latter

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cases to the extent the income is invested in active businesses in less developed countries, where the corporation in which the investment is made is, to the extent of 50 percent or more, owned by five or fewer U.S. persons, but only if the taxpayer has at least a 10-percent interest.

To the extent the 10-percent U.S. shareholders are not taxed on the income of the controlled foreign corporation under the provisions described above, they are to be subject to taxation on the undistributed earnings of the controlled foreign corporation to the extent these earnings are not invested in substantially the same trade or business as that in which the taxpayer was engaged for the prior 5 years (or on December 31, 1962), or invested in less developed countries in new trades or businesses or in the controlled subsidiaries, 50 percent or more of which is held by five or fewer U.S. persons. The 50-percent test referred to above is relaxed where the foreign country prohibits ownership by Americans and others of as much as 50 percent of the stock of a corporation established under their laws.

Undistributed earnings which are taxed to the U.S. shareholders under any of the above provisions may subsequently be actually distributed to U.S. shareholders without further payment of tax. These provisions apply to taxable years of foreign corporation beginning after December 31, 1962, and to taxable years of U.S. persons falling in such years.

14 *Ordinary income on certain gains from depreciable property.*— In the case of personal property (other than livestock) and most real estate, other than buildings and structural components, when such property is sold or exchanged at a gain, this gain, to the extent of depreciation taken for taxable years beginning after December 31, 1961, is to be treated as ordinary income for tax purposes (instead of capital gain). In the case of dispositions of property other than by sale or exchange this same treatment is to apply except that the amount of the presumed gain is to be determined by the excess of the fair market value of the property at the time of its disposition over its then adjusted basis.

This treatment is to apply in the case of most dispositions of property whether or not gain is otherwise recognized. The treatment described above does not apply, however, in the case of gifts, although in the case of charitable contributions the amount of the charitable contribution deduction which may be taken is reduced by the amount which would be treated as ordinary income if this provision were applicable. Other exceptions are provided for property transferred at death, for transfers where no gain is recognized and the basis of the property is carried over to the transferor, and for transfers in like kind exchanges and involuntary conversions to the extent no gain is recognized. In the case of partnerships, distribution to partners or sales of partnership interests are taxed to the partners to the extent of the underlying depreciable property in much the same way as if the depreciable property had been sold directly.

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The bill also provides that in computing the basis on which depreciation may be taken salvage value may be ignored up to an amount equal to 10 percent of the cost or other basis of the property. Also, under the bill taxpayers are permitted to elect to change their method of depreciation with respect to property coming within the scope of this provision from any declining balance, or sum-of-the-years digit method to a straight-line method.

This provision applies to taxable years beginning after December 31, 1961, and ending after the date of enactment of this bill.

15 *Foreign investment companies.*—When stock in foreign investment companies is sold, the gain realized by the U.S. shareholders is to be ordinary income (instead of capital gain) to the extent of the taxpayer's share of the earnings and profits of the corporation accumulated in taxable years beginning after December 31, 1962, and during the period in which he held the stock. In the case of stock in a foreign investment company acquired from a decedent, the basis of the stock is not to be increased at the date of death to the extent of the amount which would have been taxed as ordinary income to the decedent had he sold the stock before death. A deduction for estate tax attributable to this amount will be allowed, however, upon subsequent sale of this stock by the heir or legatee.

The companies and shareholders can avoid the treatment described above if the companies distribute 90 percent or more of their taxable income, other than capital gains, designate in a written notice to the shareholders each year their ratable share of the capital gains of the corporation and provide such other information as the Treasury requires to enforce this provision. The shareholders, however, must also report as capital gains their share of the capital gains of the corporation, whether the gains are distributed or not.

These provisions apply with respect to taxable years beginning after December 31, 1962.

16 *Gain from sales or exchanges of stock in foreign corporations.*—Where there is a redemption or liquidation of the stock of a controlled foreign corporation or where stock in such a corporation is sold, then any gain to the extent it represents earnings and profits of the corporation accumulated abroad is to be taxed to 10-percent U.S. shareholders as ordinary income or as dividends. In the case of the redemptions and liquidations, the earnings and profits taken into account are those accumulated since February 28, 1913. In this case, a foreign tax credit is to be allowed corporate shareholders for taxes paid to foreign countries. In the case of sales and other exchanges, the earnings and profits taken into account with respect to any shareholder is his share of profits accumulated during the period in which he held the stock. In this case, no foreign tax credit is available. These provisions apply with respect to sales or exchanges occurring after the date of enactment of this bill.

17 *Tax treatment of cooperatives and patrons.*—Cooperatives are to receive a deduction for patronage dividends paid to their

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patrons in cash or by allocations if the patron has the option to redeem the notices of allocation in cash for a 90-day period after they are issued or if he consents to this income being treated as constructively received by him and then reinvested in the cooperative. The patron, either a member or nonmember, may give his consent individually in writing. Alternatively, a patron who is a member may also consent by retaining membership in a cooperative after it adopts a bylaw requiring consent by all members and gives written notice of this bylaw to all members. In the case of allocations which do not qualify, the cooperative will initially be taxed on this type of patronage dividends. However, when such a patronage dividend is redeemed, the cooperative will receive a deduction (or refund of tax) at that time.

Where consent is given, or where the option to receive cash was available, the patron will be required to include the patronage dividends which arise from business activity as taxable income. The patron will also be required to take into account nonqualifying patronage dividends when they are redeemed (assuming they arise from business activity).

In addition, all cooperatives (rather than merely tax-exempt cooperatives as under present law) are given until 8½ months after the end of the year in which patronage occurs to allocate amounts to the accounts of their patrons and in most cases are also given this same period of time for the filing of their own income tax returns. These provisions apply to taxable years of cooperatives beginning after December 31, 1962, and with respect to amounts received by patrons attributable to years of the cooperatives to which the new law applies. The new provisions will not, however, apply to future redemptions of patronage dividends declared when the old law was applicable.

18 *Inclusion of foreign real property in gross estate.*—Real property located outside of the United States, in the case of citizens or residents of the United States, is to be included in their tax base for purposes of the Federal estate tax imposed at the time of their death. This provision will be fully effective for decedents dying on or after July 1, 1964. For those dying after the date of enactment of this bill, and before July 1, 1964, real property located outside of the United States will be included in their gross estate only if acquired on or after February 1, 1962.

19 *Withholding of tax on interest, dividends, and patronage dividends.*—Withholding at the source is provided for dividends, most interest, and patronage dividends at a rate of 20 percent. No receipts are required to be given by the payors to the taxpayers under this system and no significant change is made in the information returns which presently must be filed by the payors with the Federal Government.

No withholding is to occur in the case of dividends, savings account interest, or Government Series E bond interest if the

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recipient files an exemption certificate indicating that he is under age 18. These exemption certificates may also be filed (but on an annual basis) by those over age 18 with respect to any year in which they reasonably expect to have no income tax liability. Claims for quarterly refunds may also be filed by individuals (with gross incomes of not over $5,000 in the case of single individuals and not over $10,000 in the case of married couples) where there is expected to be significant amounts of overwithholding of their tax liability. Corporations and tax-exempt organizations may also file for quarterly refunds. In addition, corporations may credit, against amounts payable to the Government for that which the corporations withhold on their own dividend or interest payments, amounts withheld with respect to dividend or interest payments they receive. Tax-exempt organizations may also claim credits with respect to amounts withheld on the dividend and interest payments they receive against wage and salary withholding on their employees for income tax and social security tax liability.

Generally these provisions apply in the case of interest and dividends paid on or after January 1, 1963.

20 *Information with respect to foreign entities.*—A number of changes are made in the annual information return which domestic corporations presently are required to file with respect to their subsidiaries or foreign corporations which they control. The changes are: This return is to be filed not only by corporations but by others as well which control foreign corporations; "control" is defined more broadly by adding certain constructive ownership rules; information must be provided not only with respect to subsidiaries of foreign corporations but also for other foreign corporations which are further down the chain of ownership; and additional information may be required which is similar or related in nature to that already specified.

Present law also requires U.S. citizens or residents who are officers or directors of a foreign corporation within 60 days of its organization or reorganization and also 5-percent shareholders who have this status within 60 days of the organization or reorganization to supply certain information to the Treasury Department with respect to the corporation. This same information is also to be required of U.S. citizens or residents who at some later time become officers, directors, or shareholders with an interest of 5 percent or more. A penalty provision also is provided.

Generally, these additional information requirements become effective as of January 1, 1963.

21 *Treaties.*—It is made clear that any provision contained in this bill is intended to have precedence over any prior tax treaty obligation.

[H.R. 10650, 87th Cong., 2d sess.]

AN ACT To amend the Internal Revenue Code of 1954 to provide a credit for investment in certain depreciable property, to eliminate certain defects and inequities, and for other purposes.

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

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Revenue Act of 1962".

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(c) AMENDMENT OF 1954 CODE.—Whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.

(a) ALLOWANCE OF CREDIT.—Part IV of subchapter A of chapter 1 (relating to credits against tax) is amended by redesignating section 88 as section 40 and by inserting after section 87 the following new section:

"SEC. 38. INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.

"(a) GENERAL RULE.—There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

"(b) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section and subpart B."

(b) RULES FOR COMPUTING CREDIT.—Part IV of subchapter A of chapter 1 is amended by adding at the end thereof the following new subpart:

"Subpart B—Rules for Computing Credit for Investment in Certain Depreciable Property

"Sec. 46. Amount of credit.
"Sec. 47. Certain dispositions, etc., of section 38 property.
"Sec. 48. Definitions; special rules.

"SEC. 46. AMOUNT OF CREDIT.

"(a) DETERMINATION OF AMOUNT.—

"(1) GENERAL RULE.—The amount of the credit allowed by section 38 for the taxable year shall be equal to 7 percent of the qualified investment (as defined in subsection (c)).

"(2) LIMITATION BASED ON AMOUNT OF TAX.—Notwithstanding paragraph (1), the credit allowed by section 38 for the taxable year shall not exceed—

"(A) so much of the liability for tax for the taxable year as does not exceed $25,000, plus

"(B) 25 percent of so much of the liability for tax for the taxable year as exceeds $25,000.

"(3) LIABILITY FOR TAX.—For purposes of paragraph (2), the liability for tax for the taxable year shall be the tax imposed by this chapter for such year, reduced by the sum of the credits allowable under—

"(A) section 33 (relating to foreign tax credit),

"(B) section 34 (relating to dividends received by individuals),

"(C) section 35 (relating to partial tax-exempt interest); and

"(D) section 37 (relating to retirement income).

For purposes of this paragraph, any tax imposed for the taxable year by section 531 (relating to accumulated earnings tax) or by section 541 (relating to personal holding company tax) shall not be considered tax imposed by this chapter for such year.

"(4) MARRIED INDIVIDUALS.—In the case of a husband or wife who files a separate return, the amount specified under subparagraphs (A) and (B) of paragraph (2) shall be $12,500 in lieu of $25,000. This paragraph shall not apply if the spouse of the taxpayer has no qualified investment for, and no unused credit carryover to, the taxable year of such spouse which ends within or with the taxpayer's taxable year.

"(5) AFFILIATED GROUPS.—In the case of an affiliated group, the $25,000 amount specified under subparagraphs (A) and (B) of paragraph (2) shall be reduced for each member of the group by apportioning $25,000 among the members of such group in such manner as the Secretary or his delegate shall by regulations prescribe. For purposes of the preceding sentence, the term 'affiliated group' has the meaning assigned to such term by section 1504(a), except that all corporations shall be treated as includible corporations (without any exclusion under section 1504(b)).

"(b) 5-YEAR CARRYOVER OF UNUSED CREDITS.—

"(1) ALLOWANCE OF CREDIT.—If the amount of the credit determined under subsection (a)(1) for any taxable year exceeds the limitation provided by subsection (a)(2) for such taxable year (hereinafter in this subsection referred to as 'unused credit year'), such excess shall be added to the amount allowable as a credit by section 38 for each of the 5 succeeding taxable years to the extent not taken into account for taxable years intervening between the unused credit year and such succeeding taxable year.

"(2) LIMITATION.—The amount of the unused credit which may be added under paragraph (1) for any succeeding taxable year shall not exceed the amount by which the limitation provided by subsection (a)(2) for such taxable year exceeds the sum of—

"(A) the credit allowable under subsection (a)(1) for such taxable year, and

"(B) the amounts which, by reason of this subsection, are added to the amount allowable for such taxable year and attributable to taxable years preceding the unused credit year.

"(c) QUALIFIED INVESTMENT.—

"(1) IN GENERAL.—For purposes of this subpart, the term 'qualified investment' means, with respect to any taxable year, the aggregate of—

"(A) the applicable percentage of the basis of each new section 38 property (as defined in section 48(b)) placed in service by the taxpayer during such taxable year, plus

"(B) the applicable percentage of the cost of each used section 38 property (as defined in section 48(c)(1)) placed in service by the taxpayer during such taxable year.

"(2) APPLICABLE PERCENTAGE.—For purposes of paragraph (1), the applicable percentage for any property shall be determined under the following table:

"If the useful life is—	The applicable percentage is—
4 years or more but less than 6 years	33⅓
6 years or more but less than 8 years	66⅔
8 years or more	100

For purposes of this paragraph, the useful life of any property shall be determined as of the time such property is placed in service by the taxpayer.

"(3) PUBLIC UTILITY PROPERTY.—

"(A) In the case of section 38 property which is public utility property, the amount of the qualified investment shall be 3/7 of the amount determined under paragraph (1).

"(B) For purposes of subparagraph (A), the term 'public utility property' means property used predominantly in the trade or business of the furnishing or sale of—

"(i) electrical energy, water, or sewage disposal services,

"(ii) gas through a local distribution system,

"(iii) telephone service, or

"(iv) telegraph service by means of domestic telegraph operations (as defined in section 222(a)(5) of the Communications Act of 1934, as amended; 47 U.S.C., sec. 222(a)(5)),

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

"(d) LIMITATIONS WITH RESPECT TO CERTAIN PERSONS.—

"(1) IN GENERAL.—In the case of—

"(A) an organization to which section 593 applies,

"(B) a regulated investment company or a real estate investment trust subject to taxation under subchapter M (sec. 851 and following), and

"(C) a cooperative organization described in section 1381(a),

the qualified investment and the $25,000 amount specified under subparagraphs (A) and (B) of subsection (a)(2) shall equal such person's ratable share of such items.

"(2) RATABLE SHARE.—For purposes of paragraph (1), the ratable share of any person for any taxable year of the items described therein shall be—

"(A) in the case of an organization referred to in paragraph (1)(A), 50 percent thereof,

"(B) in the case of a regulated investment company or a real estate investment trust, the ratio (i) the numerator of which is its taxable income and (ii) the denominator of which is its taxable income computed without regard to the deduction for dividends paid provided by section 852(b)(2)(D) or 857(b)(2)(C), as the case may be, and

"(C) in the case of a cooperative organization, the ratio (i) the numerator of which is its taxable income and (ii) the denominator of which is its taxable income increased by amounts to which section 1382 (b) or (c) applies and similar amounts the tax treatment of which is determined without regard to subchapter T (sec. 1381 and following).

For purposes of subparagraph (B) of the preceding sentence, the term 'taxable income' means in the case of a regulated investment company its investment company taxable income (within the meaning of section 852 (b)(2)), and in the case of a real estate investment trust its real estate investment trust taxable income (within the meaning of section 857(b)(2)).

"SEC. 47. CERTAIN DISPOSITIONS, ETC., OF SECTION 38 PROPERTY.

"(a) GENERAL RULE.—Under regulations prescribed by the Secretary or his delegate—

"(1) EARLY DISPOSITION, ETC.—If during any taxable year any property is disposed of, or otherwise ceases to be section 38 property with respect to

the taxpayer, before the close of the useful life which was taken into account in computing the credit under section 38, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property.

"(2) PROPERTY BECOMES PUBLIC UTILITY PROPERTY.—If during any taxable year any property taken into account in determining qualified investment becomes public utility property (within the meaning of section 46(c)(3)(B)), then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from treating the property, for purposes of determining qualified investment, as public utility property (after giving due regard to the period before such change in use). If the application of this paragraph to any property is followed by the application of paragraph (1) to such property, proper adjustment shall be made in applying paragraph (1).

"(3) CARRYOVERS ADJUSTED.—In the case of any cessation described in paragraph (1) or any change in use described in paragraph (2), the carryovers under section 46(b) shall be adjusted by reason of such cessation (or change in use).

"(b) SECTION NOT TO APPLY IN CERTAIN CASES.—Subsection (a) shall not apply to—

"(1) a transfer by reason of death, or

"(2) a transaction to which section 381(a) applies.

For purposes of subsection (a), property shall not be treated as ceasing to be section 38 property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as section 38 property and the taxpayer retains a substantial interest in such trade or business.

"(c) SPECIAL RULE.—Any increase in tax under subsection (a) shall not be treated as tax imposed by this chapter for purposes of determining the amount of any credit allowable under subpart A.

"SEC. 48. DEFINITIONS; SPECIAL RULES.

"(a) SECTION 38 PROPERTY.—

"(1) IN GENERAL.—Except as provided in this subsection, the term 'section 38 property' means—

"(A) tangible personal property, or

"(B) other tangible property (not including a building and its structural components) but only if such property—

"(i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

"(ii) constitutes a research or storage facility used in connection with any of the activities referred to in clause (i).

Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 4 years or more.

"(2) PROPERTY USED OUTSIDE THE UNITED STATES.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'section 38 property' does not include property which is used predominantly outside the United States.

"(B) EXCEPTIONS.—Subparagraph (A) shall not apply to—

"(i) any aircraft which is registered by the Administrator of the Federal Aviation Agency and which is operated to and from the United States;

"(ii) rolling stock, of a domestic raildoad corporation subject to part I of the Interstate Commerce Act, which is used within and without the United States;

"(iii) any vessel documented under the laws of the United States which is operated in the foreign or domestic commerce of the United States;

"(iv) any motor vehicle of a United States person (as defined in section 7701(a)(30)) which is operated to and from the United States;

"(v) any container of a United States person which is used in the transportation of property to and from the United States; and

"(vi) any property (other than a vessel or an aircraft) of a United States person which is used for the purpose of exploring for, developing, removing, or transporting resources from the outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U.S.C., sec. 1331).

"(3) PROPERTY USED FOR LODGING.—Property which is used predominantly to furnish lodging or in connection with the furnishing of lodging shall not be treated as section 38 property. The preceding sentence shall not apply to—

"(A) nonlodging commercial facilities which are available to persons not using the lodging facilities on the same basis as they are available to persons using the lodging facilities, and

"(B) property used by a hotel or motel in connection with the trade or business of furnishing lodging where the predominant portion of the accommodations is used by transients.

"(4) PROPERTY USED BY CERTAIN TAX-EXEMPT ORGANIZATIONS.—Property used by an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter shall be treated as section 38 property only if such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511.

"(5) PROPERTY USED BY GOVERNMENTAL UNITS.—Property used by the United States, any State or political subdivision thereof, any international organization, or any agency or instrumentality of any of the foregoing shall not be treated as section 38 property.

"(b) NEW SECTION 38 PROPERTY.—For purposes of this subpart, the term 'new section 38 property' means section 38 property—

"(1) the construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or

"(2) acquired after December 31, 1961, if the original use of such property commences with the taxpayer and commences after such date.

In applying section 46(c)(1)(A) in the case of property described in paragraph (1), there shall be taken into account only that portion of the basis which is property attributable to construction, reconstruction, or erection after December 31, 1961.

"(c) USED SECTION 38 PROPERTY.—

"(1) IN GENERAL.—For purposes of this subpart, the term 'used section 38 property' means section 38 property acquired by purchase after December 31, 1961, which is not new section 38 property. Property shall not be treated as 'used section 38 property' if, after its acquisition by the taxpayer, it is used by a person who used such property before such acquisition (or by a person who bears a relationship described in section 179(d)(2)(A) or (B) to a person who used such property before such acquisition).

"(2) DOLLAR LIMITATION.—

"(A) IN GENERAL.—The cost of used section 38 property taken into account under section 46(c)(1)(B) for any taxable year shall not exceed $50,000. If such cost exceeds $50,000, the taxpayer shall select (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe) the items to be taken into account, but only to the extent of an aggregate cost of $50,000. Such a selection, once made, may be changed only in the manner, and to the extent, provided by such regulations.

"(B) MARRIED INDIVIDUALS.—In the case of a husband or wife who files a separate return, the limitation under subparagraph (A) shall be $25,000 in lieu of $50,000. This subparagraph shall not apply if the spouse of the taxpayer has no used section 38 property which may be taken into account as qualified investment for the taxable year of such spouse which ends within or with the taxpayer's taxable year.

"(C) AFFILIATED GROUPS.—In the case of an affiliated group, the $50,000 amount specified under subparagraph (A) shall be reduced for each member of the group by apportioning $50,000 among the members

of such group in accordance with their respective amounts of used section 38 property which may be taken into account.

"(D) PARTNERSHIPS.—In the case of a partnership, the limitation contained in subparagraph (A) shall apply with respect to the partnership and with respect to each partner.

"(3) DEFINITION.—For purposes of this subsection—

"(A) PURCHASE.—The term 'purchase' has the meaning assigned to such term by section 179(d)(2).

"(B) COST.—The cost of used section 38 property does not include so much of the basis of such property as is determined by reference to the adjusted basis of other property held at any time by the person acquiring such property. If property is disposed of and used section 38 property similar or related in service or use is acquired as a replacement therefor in a transaction to which the preceding sentence does not apply, the cost of the used section 38 property acquired shall be its basis reduced by the adjusted basis of the property replaced. The cost of used section 38 property shall not be reduced with respect to the adjusted basis of any property disposed of if, by reason of section 47, such disposition involved an increase of tax or a reduction of the unused credit carryovers described in section 46(b).

"(C) AFFILIATED GROUP.—The term 'affiliated group' has the meaning assigned to such term by section 1504(a), except that—

"(i) the phrase 'more than 50 percent' shall be substituted for the phrase 'at least 80 percent' each place it appears in section 1504(a), and

"(ii) all corporations shall be treated as includible corporations (without any exclusion under section 1504(b)).

"(d) CERTAIN LEASED PROPERTY.—A person (other than a person referred to in section 46(d)) engaged in the business of leasing property may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary or his delegate) elect with respect to any new section 38 property to treat the lessee as having acquired such property for an amount equal to—

"(1) if such property was constructed by the lessor (or by a corporation which controls or is controlled by the lessor within the meaning of section 368(c)), the fair market value of such property, or

"(2) if paragraph (1) does not apply, the basis of such property to the lessor.

The election provided by the preceding sentence may be made only with respect to property which would be new section 38 property if acquired by the lessee. For purposes of the preceding sentence and section 46(c), the useful life of property in the hands of the lessee is the useful life of such property in the hands of the lessor. If a lessor makes the election provided by this subsection with respect to any property, the lessee shall be treated for all purposes of this subpart as having acquired such property.

"(e) SUBCHAPTER S CORPORATIONS.—In the case of an electing small business corporation (as defined in section 1371)—

"(1) the qualified investment for each taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such taxable year; and

"(2) any person to whom any investment has been apportioned under paragraph (1) shall be treated (for purposes of this subpart) as the taxpayer with respect to such investment, and such investment shall not (by reason of such apportionment) lose its character as an investment in new section 38 property or used section 38 property, as the case may be.

"(f) ESTATES AND TRUSTS.—In the case of an estate or trust—

"(1) the qualified investment for any taxable year shall be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each.

"(2) any beneficiary to whom any investment has been apportioned under paragraph (1) shall be treated (for purposes of this subpart) as the taxpayer with respect to such investment, and such investment shall not (by reason of such apportionment) lose its character as an investment in new section 38 property or used section 38 property, as the case may be, and

"(3) the $25,000 amount specified under subparagraphs (A) and (B) of section 46(a)(2) applicable to such estate or trust shall be reduced to an amount which bears the same ratio to $25,000 as the amount of the qualified investment allocated to the estate or trust under paragraph (1) bears to the entire amount of the qualified investment.

"(g) CROSS REFERENCE.—

"For application of this subpart to certain acquiring corporations, see section 381(c)(23)."

(c) CERTAIN CORPORATE ACQUISITIONS.—Section 381(c) (relating to items taken into account in certain corporate acquisitions) is amended by adding at the end thereof the following new paragraph:

"(23) CREDIT UNDER SECTION 38 FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 38, and under such regulations as may be prescribed by the Secretary or his delegate) the items required to be taken into account for purposes of section 38 in respect of the distributor or transferor corporation."

(d) CLERICAL AMENDMENT.—Part IV of subchapter A of chapter 1 is amended by inserting after the heading and before the table of sections the following:

"Subpart A. Credits allowable.
"Subpart B. Rules for computing credit for investment in certain depreciable property.

"Subpart A—Credits Allowable"

(e) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years ending after December 31, 1961.

SEC. 3. APPEARANCES, ETC., WITH RESPECT TO LEGISLATION.

(a) IN GENERAL.—Section 162 (relating to trade or business expenses) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) APPEARANCES, ETC., WITH RESPECT TO LEGISLATION.—

"1) IN GENERAL.—The deduction allowed by subsection (a) shall include all the ordinary and necessary expenses (including, but not limited to, traveling expenses described in subsection (a)(2) and the cost of preparing testimony) paid or incurred during the taxable year in carrying on any trade or business—

"(A) in direct connection with appearances before, submission of statements to, or sending communications to, the committees, or individual members, of Congress or of any legislative body of a State, a possession of the United States, or a political subdivision of any of the foregoing with respect to legislation or proposed legislation of direct interest to the taxpayer, or

"(B) in direct connection with communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization,

and that portion of the dues so paid or incurred with respect to any organization of which the taxpayer is a member which is attributable to the expenses of the activities described in subparagraphs (A) and (B) carried on by such organization.

"(2) LIMITATION.—The provisions of paragraph (1) shall not be construed as allowing the deduction of any amount paid or incurred (whether by way of contribution, gift, or otherwise)—

"(A) for participation in, or intervention in, any political campaign on behalf of any candidate for public office, or

"(B) in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1962.

SEC. 4. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

(a) DENIAL OF DEDUCTION.—

(1) Part IX of subchapter B of chapter 1 (relating to items not deductible in computing taxable income) is amended by adding at the end thereof the following new section:

"SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

"(a) ENTERTAINMENT, AMUSEMENT, OR RECREATION.—

"(1) IN GENERAL.—No deduction otherwise allowable under this chapter shall be allowed for any item—

"(A) ACTIVITY.—With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business, or

"(B) FACILITY.—With respect to a facility used in connection with an activity referred to in subparagraph (A), unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business,

and such deduction shall in no event exceed the portion of such item directly related to the active conduct of the taxpayer's trade or business.

"(2) SPECIAL RULES.—For purposes of applying paragraph (1)—

"(A) Dues or fees to any social, athletic, or sporting club or organization shall be treated as items with respect to facilities.

"(B) An activity described in section 212 shall be treated as a trade or business.

"(b) GIFTS.—

"(1) LIMITATION.—No deduction shall be allowed under section 162 or section 212 for any expense for gifts made directly or indirectly to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds $25. For purposes of this section, the term 'gift' means any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of this chapter.

"(2) SPECIAL RULES.—

"(A) In the case of a gift by a partnership, the limitation contained in paragraph (1) shall apply to the partnership as well as to each member thereof.

"(B) For purposes of paragraph (1), a husband and wife shall be treated as one taxpayer.

"(c) SUBSTANTIATION REQUIRED.—No deduction shall be allowed—

"(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

"(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, or

"(3) for any expense for gifts,

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift. The Secretary or his delegate may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations.

"(d) SPECIFIC EXCEPTIONS TO APPLICATION OF SUBSECTION (a).—Subsection shall not apply to—

"(1) BUSINESS MEALS.—Expenses for food and beverages furnished to any individual under circumstances which (taking into account the surroundings in which furnished, the taxpayer's trade, business, or income-producing activity and the relationship to such trade, business, or activity of the persons to whom the food and beverages are furnished) are of a type generally considered to be conducive to a business discussion.

"(2) FOOD AND BEVERAGES FOR EMPLOYEES.—Expenses for food and beverages (and facilities used in connection therewith) furnished on the business premises of the taxpayer primarily for his employees.

"(3) EXPENSES TREATED AS COMPENSATION.—Expenses for goods, services, and facilities, to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation to an employee on the taxpayer's return of tax under this chapter and as wages to such employee for purposes of chapter 24 (relating to withholding of income tax at source on wages).

"(4) REIMBURSED EXPENSES.—Expenses paid or incurred by the taxpayer, in connection with the performance by him of services for another person (whether or not such other person is his employer), under a reimbursement or other expense allowance arrangement with such other person, but this paragraph shall apply—

"(A) where the services are performed for an employer, only if the employer has not treated such expenses in the manner provided in paragraph (3), or

"(B) where the services are performed for a person other than an employer, only if the taxpayer accounts (to the extent provided by subsection (c)) to such person.

"(5) RECREATIONAL, ETC., EXPENSES FOR EMPLOYEES.—Expenses for recreational, social, or similar activities (including facilities therefor) primarily for the benefit of employees (other than employees who are officers, shareholders or other owners, or highly compensated employees). For purposes of this paragraph, an individual owning less than a 10-percent interest in taxpayer's trade or business shall not be considered a shareholder or other owner, and for such purposes an individual shall be treated as owning any interest owned by a member of his family (within the meaning of section 267(c)(3)).

"(6) EMPLOYEE AND STOCKHOLDER BUSINESS MEETINGS.—Expenses directly related to business meetings of employees or stockholders.

"(7) MEETINGS OF BUSINESS LEAGUES, ETC.—Expenses directly related and necessary to attendance at a business meeting or convention of any organization described in section 501(c)(6) (relating to business leagues, chambers of commerce, real estate boards, and boards of trade) and exempt from taxation under section 501(a).

"(8) ITEMS AVAILABLE TO PUBLIC.—Expenses for goods, services, and facilities made available by the taxpayer to the general public.

"(9) ENTERTAINMENT SOLD TO CUSTOMERS.—Expenses for goods or services (including the use of facilities) which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth.

For purposes of this subsection, any item referred to in subsection (a) shall be treated as an expense.

"(e) INTEREST, TAXES, CASUALTY LOSSES, 593.—This section shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity). In the case of a taxpayer which is not an individual, the preceding sentence shall be applied as if it were an individual.

"(f) TREATMENT OF ENTERTAINMENT, ETC., TYPE FACILITY.—For purposes of this chapter, if deductions are disallowed under subsection (a) with respect to any portion of a facility, such portion shall be treated as an asset which is used for personal, living, and family purposes (and not as an asset used in the trade or business).

"(g) REGULATORY AUTHORITY.—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to carry out the purposes of this section, including regulations prescribing whether subsection (a) or subsection (b) applies in cases where both such subsections would otherwise apply."

(2) The table of sections for such part IX is amended by adding at the end thereof the following:

"Sec. 274. Disallowance of certain entertainment, etc., expenses."

(b) TRAVELING EXPENSES.—Section 162(a)(2) (relating to traveling expenses) is amended by striking out "(including the entire amount expended for meals and lodging)" and inserting in lieu thereof "(including a reasonable allowance for amounts expended for meals and lodging)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years ending after June 30, 1962, but only in respect of periods after such date.

SEC. 5. AMOUNT OF DISTRIBUTION WHERE CERTAIN FOREIGN CORPORATIONS DISTRIBUTE PROPERTY IN KIND.

(a) AMOUNT DISTRIBUTED.—Section 301(b)(1) (relating to amount distributed to corporate distributees) is amended by adding at the end thereof the following new subparagraph:

"(C) CERTAIN CORPORATE DISTRIBUTEES OF FOREIGN CORPORATION.—Notwithstanding subparagraph (B), if the shareholder is a corporation and the distributing corporation is a foreign corporation, the amount taken into account with respect to property (other than money) shall be the fair market value of such property; except that if any deduction is allowable under section 245 with respect to such distribution, then the amount taken into account shall be the sum (determined under regulations prescribed by the Secretary or his delegate) of—

"(i) the proportion of the adjusted basis of such property (or, if lower, its fair market value) properly attributable to gross income from sources within the United States, and

"(ii) the proportion of the fair market value of such property properly attributable to gross income from sources without the United States."

(b) BASIS.—Section 301(d) (relating to basis of property) is amended by adding at the end thereof the following new paragraph:

"(3) CERTAIN CORPORATE DISTRIBUTEES OF FOREIGN CORPORATION.—In the case of property described in subparagraph (C) of subsection (b)(1), the basis shall be determined by substituting the amount determined under such subparagraph (C) for the amount described in paragraph (2) of this subsection."

(c) DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS.—

(1) Section 245 (relating to dividends received from certain foreign corporations) is amended by adding at the end thereof the following new subsection:

"(b) PROPERTY DISTRIBUTIONS.—For purposes of subsection (a), the amount of any distribution of property other than money shall be the amount determined by applying section 301(b)(1)(B)."

(2) Section 245 is amended by striking out "In the case of" and inserting in lieu thereof "(a) GENERAL RULE.—In the case of".

(d) CREDIT FOR FOREIGN TAXES.—Section 902(a) (relating to credit for foreign taxes) is amended by adding at the end thereof the following new sentence: "For purposes of this subsection and subsection (b), the amount of any distribution in property other than money shall be the amount determined by applying section 301(b)(1)(B)."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions made after December 31, 1962.

SEC. 6. AMENDMENT OF SECTION 482.

(a) IN GENERAL.—Section 482 (relating to allocation of income and deductions among taxpayers) is amended by adding at the end thereof the following new subsection:

"(b) SALES AND PURCHASES WITHIN A RELATED GROUP WHICH INCLUDES A FOREIGN ORGANIZATION.—

"(1) IN GENERAL.—In applying subsection (a) to sales of tangible property within a group of organizations—

"(A) owned or controlled directly or indirectly by the same interests, and

"(B) at least one of which is a domestic organization and at least one of which is a foreign organization,

the Secretary or his delegate may allocate the taxable income of the group arising from such sales in the manner set forth in paragraph (2). This subsection shall not apply with respect to any sale of tangible property for which the taxpayer can establish an arm's length price (within the meaning of paragraph (4)).

"(2) METHODS OF ALLOCATION.—

"(A) CONSIDERATION OF CERTAIN FACTORS.—Except as provided in subparagraph (B), the allocation referred to in paragraph (1) shall be made by the Secretary or his delegate by taking into consideration that portion of the following factors which is attributable to the United States and that portion thereof which is not attributable to the United States—

"(i) assets of the group, to the extent used in the production, distribution, and sale of the property,

"(ii) compensation of officers and employees, to the extent at-
including the special risks (if any) of the market in which the property
and

"(iii) advertising, selling, and sales promotion expenses (including technical and servicing expenses), to the extent attributable to the property.

Such method of allocation may also give consideration to other factors, including the special risks (if any) of the mraket in which the property is sold.

"(B) ALTERNATIVE METHODS.—If the taxpayer establishes to the satisfaction of the Secretary or his delegate that an alternative method of allocation clearly reflects the income of each member of the group with respect to the property referred to in paragraph (1), such alternative method shall be used (in lieu of the method provided in subparagraph (A)).

"(3) SPECIAL RULES.—In applying the method of allocation referred to in paragraph (2)(A), the following rules shall be applied:

"(A) ADJUSTED BASIS OF ASSETS.—The values to be assigned to the assets referred to in paragraph (2)(A)(i) is their adjusted basis in the hands of the taxpayer or, if such basis is not available in the case of a foreign organization, then their book values, adjusted to approximate their adjusted basis.

"(B) INCLUDIBLE ASSETS.—The assets referred to in paragraph (2)(A)(i) include real property and tangible personal property (whether owned or leased by a member of the group), but do not include inventory and stock in trade.

"(4) ARMS'S LENGTH PRICE DEFINED.—For purposes of this subsection, the term 'arm's length price' means—

"(A) the price at which tangible property similar or comparable to the property referred to in paragraph (1) generally is or can be sold in transactions in the same areas involving unrelated persons and made under similar conditions of sale; and

"(B) if subparagraph (A) does not apply, the price at which tangible property similar or comparable to the property referred to in paragraph (1) is sold in the same or other areas under similar circumstances and in transactions involving unrelated persons, with adjustment for material differences in quantity, marketing conditions (including customs duties and transportation costs), and other relevant factors.

Subparagraph (B) shall apply only if the adjustment referred to therein is properly determinable.

"(5) SALES COMMISSIONS.—The Secretary or his delegate shall by regulation prescribe rules for the allocation of commissions arising from sales of tangible property within a group of organizations described in paragraph (1). Such rules shall be consistent with the principles specified in the other paragraphs of this subsection.

"(6) GROSSLY INADEQUATE ASSETS, ETC., OUTSIDE UNITED STATES.—In allocating taxable income under this subsection, no amount shall be allocated to a foreign organization whose assets, personnel, and office and other facilities which are not attributable to the United States are grossly inadequate for its activities outside the United States.

"(7) INFORMATION NECESSARY FOR CONSIDERATION OF FACTORS.—In the case of any transaction to which paragraph (2)(A) applies, if—

"(A) the information submitted with respect to the group of organizations is insufficient for the proper application of the method of allocation set forth in the first sentence of such paragraph, and

"(B) upon request of the Secretary or his delegate, such group fails to furnish such additional information with respect to such transaction as may be reasonably supplied.

the Secretary or his delegate may estimate the taxable income arising from such transaction and may allocate such taxable income among the members of the group or to any single member thereof.

"(8) TREATMENT OF FOREIGN TAXES.—

"(A) For purposes of this subsection, taxable income shall be determined without regard to any income, war profits, or excess profits taxes paid to any foreign country or to any possession of the United States.

"(B) Where the application of this subsection results in a decrease in the taxable income of any foreign organization and an increase in the taxable income of any domestic organization, then any of the taxes referred to in subparagraph (A) paid by such foreign organization and attributable to the taxable income so transferred shall be treated for purposes of this chapter—

"(i) as paid by such domestic organization, and

"(ii) as not paid by such foreign organization."

(b) CLERICAL AMENDMENT.—Section 482 is amended by striking out "In any case of two or more organizations" and inserting in lieu thereof the following:

"(a) GENERAL RULE.—In the case of two or more organizations".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1962.

SEC. 7. DISTRIBUTIONS OF FOREIGN PERSONAL HOLDING COMPANY INCOME.

(a) DEFINITION OF FOREIGN PERSONAL HOLDING COMPANY.—So much of subsection (a) of section 552 (relating to definition of foreign personal holding company) as precedes paragraph (2) is amended to read as follows:

"(a) GENERAL RULE.—For purposes of this subtitle, the term 'foreign personal holding company' for a taxable year beginning after December 31, 1962, means any foreign corporation if—

"(1) GROSS INCOME REQUIREMENT.—At least 20 percent of its gross income (as defined in section 555(a)) for the taxable year is foreign personal holding company income (as defined in section 553). For purposes of this paragraph, there shall be included in the gross income the amount includible therein as a dividend by reason of the application of section 555(c)(2); and".

(b) AMOUNT OF UNDISTRIBUTED INCOME.—Subsection (a) of section 556 (relating to undistributed foreign personal holding company income) is amended to read as follows:

"(a) DEFINITION.—For purposes of this part—

"(1) If the foreign personal holding company income of a foreign personal holding company exceeds 80 percent of its gross income, the 'undistributed foreign personal holding company income' of such company is its taxable income adjusted in the manner provided in subsection (b), minus the dividends paid deduction (as defined in section 561).

"(2) If the foreign personal holding company income of a foreign personal holding company does not exceed 80 percent of its gross income, the 'undistributed foreign personal holding company income' of such company is that amount which bears the same ratio to—

"(A) its taxable income adjusted in the manner provided in subsection (b), minus the dividends paid deduction (as defined in section 561), as

"(B) its foreign personal holding company income bears to its gross income."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply only in respect of taxable years of foreign corporations beginning after December 31, 1962.

SEC. 8. MUTUAL SAVINGS BANKS, ETC.

(a) RESERVES FOR LOSSES ON LOANS.—Section 593 is amended to read as follows:

"SEC. 593. RESERVES FOR LOSSES ON LOANS.

"(a) ORGANIZATIONS TO WHICH SECTION APPLIES.—This section shall apply to any mutual savings bank not having capital stock represented by shares, domestic building and loan association, or cooperative bank without capital stock organized and operated for mutual purposes and without profit.

"(b) ADDITION TO RESERVES FOR BAD DEBTS.—

"(1) IN GENERAL.—For purposes of section 166(c), the reasonable addition for the taxable year to the reserve for bad debts of any taxpayer described in subsection (a) shall be an amount equal to the sum of—

"(A) the amount determined under section 166(c) to be a reasonable addition to the reserve for losses on nonqualifying loans, plus

"(B) the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans, but such amount shall not exceed the amount determined under paragraph (2), (3), or (4), whichever amount is the largest.

"(2) 60 PERCENT OF TAXABLE INCOME METHOD.—The amount determined under this paragraph for the taxable year shall be the excess of—

"(A) an amount equal to 60 percent of the taxable income for such year, over

"(B) the amount referred to in paragraph (1)(A) for such year.

For purposes of this paragraph, taxable income shall be computed (i) by excluding from gross income any amount included therein by reason of subsection (f), and (ii) without regard to any deduction allowable for any addition to the reserve for bad debts.

"(3) 3 PERCENT OF REAL PROPERTY LOANS METHOD.—The amount determined under this paragraph for the taxable year shall be an amount equal to the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at such time.

"(4) EXPERIENCE METHOD.—The amount determined under this paragraph for the taxable year shall be an amount equal to the amount determined under section 166(c) (without regard to this subsection) to be a reasonable addition to the reserve for losses on qualifying real property loans.

"(c) TREATMENT OF RESERVES FOR BAD DEBTS.—

"(1) ESTABLISHMENT OF RESERVES.—Each taxpayer described in subsection (a) which uses the reserve method of accounting for bad debts shall establish and maintain a reserve for losses on qualifying real property loans, a reserve for losses on nonqualifying loans, and a supplemental reserve for losses on loans. For purposes of this title, such reserves shall be treated as reserves for bad debts, but no deduction shall be allowed for any addition to the supplemental reserve for losses on loans.

"(2) ALLOCATION OF PRE-1963 RESERVES.—For purposes of this section, the pre-1963 reserves shall, as of the close of December 31, 1962, be allocated to, and constitute the opening balance of—

"(A) the reserve for losses on nonqualifying loans,

"(B) the reserve for losses on qualifying real property loans, and

"(C) the supplemental reserve for losses on loans.

"(3) METHOD OF ALLOCATION.—The allocation provided by paragraph (2) shall be made—

"(A) first, to the reserve described in paragraph (2)(A), to the extent such reserve is not increased above the amount which would be a reasonable addition under section 166(c) for a period in which the nonqualifying loans increased from zero to the amount thereof outstanding at the close of December 31, 1962;

"(B) second, to the reserve described in paragraph (2)(B), to the extent such reserve is not increased above the amount which would be determined under paragraph (3) or (4) of subsection (b) (whichever such amount is the larger) for a period in which the qualifying real

property loans increased from zero to the amount thereof outstanding at the close of December 31, 1962; and

"(C) then to the supplemental reserve for losses on loans.

"(4) PRE-1963 RESERVES DEFINED.—For purposes of this subsection, the term 'pre-1963 reserves' means the net amount, determined as of the close of December 31, 1962 (after applying subsection (d)(1)), accumulated in the reserve for bad debts pursuant to section 166(c) (or the corresponding provisions of prior revenue laws) for taxable years beginning after December 31, 1951.

"(5) CHARGING OF BAD DEBTS TO RESERVES.—Any debt becoming worthless or partially worthless in respect of a qualifying real property loan shall be charged to the reserve for losses on such loans, and any debt becoming worthless or partially worthless in respect of a nonqualifying loan shall be charged to the reserve for losses on nonqualifying loans; except that any such debt may, at the election of the taxpayer, be charged in whole or in part to the supplemental reserve for losses on loans.

"(d) TAXABLE YEARS BEGINNING IN 1962 AND ENDING IN 1963.—In the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, of a taxpayer described in subsection (a) which uses the reserve method of accounting for bad debts, the taxable income shall be of the sum of—

"(1) that portion of the taxable income allocable to the part of the taxable year occurring before January 1, 1963, reduced by the amount of the deduction for an addition to a reserve for bad debts which would be allowable under section 166(c) (without regard to the amendments made by section 8 of the Revenue Act of 1962) if such part year constituted a taxable year, plus

"(2) that portion of the taxable income allocable to the part of the taxable year occurring after December 31, 1962, reduced by the amount of the deduction for an addition to a reserve for bad debts which would be allowed under section 166(c) (taking into account the amendments made by section 8 of the Revenue Act of 1962) if such part year constituted a taxable year.

For purposes of the preceding sentence, the taxable income shall be determined without regard to any deduction under section 166(c), and the portion thereof allocable to each part year shall be determined on the basis of the ratio which the number of days in such part year bears to the number of days in the entire taxable year.

"(e) LOANS DEFINED.—For purposes of this section—

"(1) QUALIFYING REAL PROPERTY LOANS.—The term 'qualifying real property loan' means any loan secured by an interest in improved real property or secured by an interest in real property which is to be improved out of the proceeds of the loan, but such term does not include—

"(A) any loan evidenced by a security (as defined in section 165(g)(2)(C));

"(B) any loan, whether or not evidenced by a security (as defined in section 165(g)(2)(C)), the primary obligor on which is—

"(i) a government or political subdivision or instrumentality thereof;

"(ii) a bank (as defined in section 581); or

"(iii) another member of the same affiliated group;

"(c) any loan, to the extent secured by a deposit in or share of the taxpayer; or

"(D) any loan which, within a 60-day period beginning in one taxable year of the creditor and ending in its next taxable year, is made or acquired and then repaid or disposed of, unless the transactions by which such loan was made or acquired and then repaid or disposed of are established to be for bona fide business purposes.

For purposes of subparagraph (B) (iii), the term 'affiliated group' has the meaning assigned to such term by section 1504(a); except that (i) the phrase 'more than 50 percent' shall be substituted for the phrase 'at least 80 percent' each place it appears in section 1504 (a), and (ii) all corporations shall be treated as includible corporations (without any exclusion under section 1504(b)).

"(2) NONQUALIFYING LOANS.—The term 'non-qualifying loan' means any loan which is not a qualifying real property loan.

"(3) LOAN.—The term 'loan' means debt, as the term 'debt' is used in section 166.

"(f) DISTRIBUTIONS TO SHAREHOLDERS.—

"(1) IN GENERAL.—For purposes of this chapter, any distribution of property (as defined in section 317(a)) by a domestic building and loan association to a shareholder with respect to its stock, if such distribution is not allowable as a deduction under section 591, shall be treated as made—

"(A) first out of its earnings and profits accumulated in taxable years beginning after December 31, 1951, to the extent thereof,

"(B) then out of the reserve for losses on qualifying real property loans, to the extent additions to such reserve exceed the additions which would have been allowed under subsection (b)(4),

"(C) then out of the supplemental reserve for losses on loans, to the extent thereof.

"(D) then out of such other accounts as may be proper.

This paragraph shall apply in the case of any distribution in redemption of stock or in partial or complete liquidation of the association, except that any such distribution shall be treated as made first out of the amount referred to in subparagraph (B), second out of the amount referred to in subparagraph (C), third out of the amount referred to in subparagraph (A), and then out of such other accounts as may be proper.

"(2) AMOUNTS CHARGED TO RESERVE ACCOUNTS AND INCLUDED IN GROSS INCOME.—If any distribution is treated under paragraph (1) as having been made out of the reserves described in subparagraphs (B) and (C) of such paragraph, the amount charged against such reserve shall be the amount which, when reduced by the amount of tax imposed under this chapter and attributable to the inclusion of such amount in gross income, is equal to the amount of such distribution; and the amount so charged against such reserve shall be included in gross income of the taxpayer.

"(3) SPECIAL RULES.—

"(A) For purposes of paragraph (1)(B), additions to the reserve for losses on qualifying real property loans for the taxable year in which the distribution occurs shall be taken into account.

"(B) For purposes of computing under this section the amount of a reasonable addition to the reserve for losses on qualifying real property loans for any taxable year, any amount charged during any year to such reserve pursuant to the provisions of paragraph (2) shall not be taken into account."

(b) FORECLOSURE ON PROPERTY SECURING LOANS.—Part II of subchapter H of chapter 1 (relating to mutual savings banks, etc.) is amended by adding at the end thereof the following new section:

"SEC. 595. FORECLOSURE ON PROPERTY SECURING LOANS.

"(a) NONRECOGNITION OF GAIN OR LOSS AS A RESULT OF FORECLOSURE.—In the case of a creditor which is an organization described in section 593(a), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless, as the result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness.

"(b) CHARACTER OF PROPERTY.—For purposes of sections 166 and 1221, any property acquired in a transaction with respect to which gain or loss to an organization was not recognized by reason of subsection (a) shall be considered as property having the same characteristics as the indebtedness for which such property was security. Any amount realized by such organization with respect to such property shall be treated for purposes of this chapter as a payment on account of such indebtedness, and any loss with respect thereto shall be treated as a bad debt to which the provisions of section 166 (relating to allowance of a deduction for bad debts) apply.

"(c) BASIS.—The basis of any property to which subsection (a) applies shall be the basis of the indebtedness for which such property was security (determined as of the date of the acquisition of such property), properly increased for costs of acquisition.

"(d) REGULATORY AUTHORITY.—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to carry out the purposes of this section."

(c) DEFINITION OF DOMESTIC BUILDING AND LOAN ASSOCIATION.—Paragraph (19) of section 7701(a) (definition of domestic building and loan association) is amended to read as follows:

"(19) DOMESTIC BUILDING AND LOAN ASSOCIATION.—The term 'domestic building and loan association' means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association, which—

"(A) is an insured institution (within the meaning of section 401(a) of the National Housing Act (12 U.S.C., sec. 1724(a))), or

"(B) is subject by law to supervision and examination by State or Federal authority having supervision over such associations,

if substantially all of its business consists of accepting savings and investing the proceeds (i) in loans secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property, and (ii) in other loans, to the extent such other loans would be authorized to be made by a Federal savings and loan association under section 5(c) of the Home Owners' Loan Act, as amended (12 U.S.C., sec. 1464(c))."

(d) CLERICAL AMENDMENTS.—The table of sections for part II of subchapter H of chapter 1 is amended—

(1) by striking out the third item and inserting in lieu thereof the following:

"Sec. 595. Foreclosure on property securing loans."

and

(2) by adding at the end thereof the following:

"Sec. 595. Foreclosure on roperty securing loans."

(e) REPEAL OF EXEMPTION FROM COMMUNICATIONS AND TRANSPORTATION OF PERSONS TAXES.—Notwithstanding any other provision of law, Federal savings and loan associations shall not be exempt as such from the taxes imposed by section 4251 (relating to excise tax on communications) and section 4261 (relating to excise tax on transportation of persons) of the Internal Revenue Code of 1954.

(f) EFFECTIVE DATES.—

(1) The amendment made by subsection (a) shall apply to taxable years ending after December 31, 1962, except that section 593(f) of the Internal Revenue Code of 1954 shall apply to distributions after December 31, 1962, in taxable years ending after such date.

(2) The amendment made by subsection (b) shall apply to transactions described in section 595(a) of the Internal Revenue Code of 1954 occurring after December 31, 1962, in taxable years ending after such date.

(3) Subsection (e) of this section shall apply—

(A) in the case of the tax imposed by section 4251 of the Internal Revenue Code of 1954, with respect to amounts paid pursuant to bills rendered after June 30, 1962; and

(B) in the case of the tax imposed by section 4261 of such Code, with respect to transportation beginning after June 30, 1962.

SEC. 9. DISTRIBUTIONS BY FOREIGN TRUSTS.

(a) DEFINITIONS.—

(1) INCOME OF FOREIGN TRUST.—Section 643(a)(6) (relating to modifications taken into account in computing distributable net income) is amended to read as follows:

"(6) INCOME OF FOREIGN TRUST.—In the case of a foreign trust—

"(A) There shall be included the amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of section 265(1) (relating to disallowance of certain deductions).

"(B) Gross income from sources within the United States shall be determined without regard to section 894 (relating to income exempt under treaty).

"(C) Subsection (a)(3) of this section shall not apply to a foreign trust created by a United States person. In the case of such a trust, (i) there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchange, and (ii) the deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account."

(2) FOREIGN ESTATES AND TRUSTS.—Section 643 (relating to definitions) is amended by adding at the end thereof the following new subsection:

"(d) FOREIGN TRUSTS CREATED BY UNITED STATES PERSONS.—For purposes of this part, the term 'foreign trust created by a United States person' means a foreign trust (as defined in section 7701(a)(31)) to which money or property has been transferred directly or indirectly by a United States person (as defined in section 7701(a)(30)), or under the will of a decedent who at the date of his death was a United States citizen or resident."

(b) ACCUMULATION DISTRIBUTIONS OF FOREIGN TRUSTS.—

(1) Section 665(b) (relating to definitions applicable to subpart D) is amended by striking out "(b) ACCUMULATION DISTRIBUTION.—For purposes of this subpart," and inserting in lieu thereof the following:

"(b) ACCUMULATION DISTRIBUTIONS OF TRUSTS OTHER THAN CERTAIN FOREIGN TRUSTS.—For purposes of this subpart, in the case of a trust (other than a foreign trust created by a United States person),".

(2) Section 665 is amended by redesignating subsections (c) and (d) as (d) and (e), respectively, and by inserting after subsection (b) the following new subsection:

"(c) ACCUMULATION DISTRIBUTION OF CERTAIN FOREIGN TRUSTS.—For purposes of this subpart, in the case of a foreign trust created by a United States person, the term 'accumulation distribution' for any taxable year of the trust means the amount by which the amounts specified in paragraph (2) of section 661(a) for such taxable year exceed distributable net income, reduced by the amounts specified in paragraph (1) of section 661(a). For purposes of this subsection, the amount specified in paragraph (2) of section 661(a) shall be determined without regard to section 666. Any amount paid to a United States person which is from a payor who is not a United States person and which is derived directly or indirectly from a foreign trust created by a United States person shall be deemed in the year of payment to have been directly paid by the foreign trust."

(c) ALLOCATION OF ACCUMULATION DISTRIBUTIONS TO PRECEDING YEARS.—Section 666(a) (relating to accumulation distribution allocated to 5 preceding years) is amended—

(1) by striking out "(a) AMOUNT ALLOCATED.—In the case of a trust" and inserting in lieu thereof the following:

"(a) AMOUNT ALLOCATED.—In the case of a trust (other than a foreign trust created by a United States person)"; and

(2) by adding at the end thereof the following new sentence:

"In the case of a foreign trust created by a United States person, this subsection shall apply to the preceding taxable years of the trust without regard to any provision of the preceding sentences which would (but for this sentence) limit its application to the 5 preceding taxable years."

(d) AMOUNTS TREATED AS RECEIVED IN PRIOR YEARS.—Section 668(a) (relating to amounts treated as received in prior taxable years) is amended by adding at the end thereof the following new sentence: "Except as provided in section 669, in the case of a foreign trust created by a United States person the preceding sentence shall not apply to any beneficiary who is a United States person."

(e) SPECIAL RULES FOR FOREIGN TRUSTS.—Subpart D of part I of subchapter J of chapter 1 (relating to treatment of excess distributions by trusts) is amended by adding at the end thereof the following new section:

"SEC. 669. SPECIAL RULES APPLICABLE TO CERTAIN FOREIGN TRUSTS.

"(a) LIMITATION ON TAX.—

"(1) GENERAL RULE.—At the election of a beneficiary who is a United States person (as defined in section 7701(a)(30) and who satisfies the requirements of subsection (b), the tax attributable to the amounts treated under section 668(a) as having been received by him from a foreign trust created by a United States person on the last day of a preceding taxable year of the trust shall not be greater than—

"(A) the tax determined under the next to the last sentence of section 668(a), or

"(B) the tax determined by multiplying by the number of preceding taxable years of the trust, on the last day of each of which an amount is deemed under section 666(a) to have been distributed, the average of the increase in tax attributable to recomputing the beneficiary's gross income for the taxable year and each of his 2 taxable years immediately preceding the year of the accumulation distribution by adding to the income of each of such years an amount determined by dividing the

amount required to be included in income under section 668(a) by such number of preceding taxable years of the trust. The recomputation for the taxable year shall be made without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to this paragraph.

"(2) EXCEPTIONS.—

"(A) When an accumulation distribution is deemed under section 666(a) to have been distributed on the last day of less than 3 taxable years of the trust, the taxable years of the beneficiary for which a recomputation is made under subsection (a)(1)(B) shall equal the number of years to which section 666(a) applies, commencing with the most recent taxable year of the beneficiary.

"(B) If a beneficiary was not alive on the last day of each preceding taxable year of the trust with respect to which a distribution is deemed made under section 666(a), paragraph (1)(A) of this subsection shall not apply. In applying paragraph (1)B) of this subsection, no recomputation shall be made for a beneficiary for a taxable year for which he was not alive; if he has no preceding taxable year, the recomputation shall be made on the basis of his taxable year without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to paragraph (1)(B).

"(3) EFFECT OF PRIOR ELECTION.—In computing the limitation on tax under paragraph (1) of this subsection for any beneficiary—

"(A) SUBSEQUENT ELECTION UNDER PARAGRAPH (1)(A).—If an election has been made under paragraph (1)(B) of this subsection, for purposes of a subsequent election under paragraph (1)(A) the income of any year with respect to which an amount is deemed distributed to a beneficiary under section 666(a) shall include amounts previously deemed distributed to such beneficiary for such year as a result of an accumulation distribution with respect to which an election under paragraph (1)(B) was made.

"(B) SUBSEQUENT ELECTION UNDER PARAGRAPH (1)(B).—If with respect to an accumulation distribution an election has been made under either paragraph (1)(A) or paragraph (1)(B) of this subsection, or the next to the last sentence of section 668(a) has applied, for purposes of a subsequent election under paragraph (1)(B) the number of preceding taxable years of the trust with respect to which an amount is deemed distributed to a beneficiary under section 666(a) shall be determined without regard to any such year with respect to which an amount was previously deemed distributed to such beneficiary.

"(b) INFORMATION REQUIREMENT.—The election of a beneficiary to apply the limitations on tax provided in subsection (a) of this section shall not be effective unless the beneficiary at the time of making the election supplies such information with respect to the operation and accounts of the trust, for each taxable year on the last day of which an amount is deemed distributed under section 666(a), as the Secretary or his delegate may by regulations prescribe."

(f) INFORMATION RETURNS WITH RESPECT TO FOREIGN TRUSTS.—Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by adding at the end thereof the following new section:

"SEC. 6047. RETURNS AS TO CREATION OF OR TRANSFEREES TO CERTAIN FOREIGN TRUSTS.

"(a) GENERAL RULE.—On or before the 90th day after—

"(1) the creation of any foreign trust by a United States person, or

"(2) the transfer of any money or property to a foreign trust by a United States person,

the grantor in the case of an inter vivos trust, the fiduciary of an estate in the case of a testamentary trust, or the transferor, as the case may be, shall make a return in compliance with the provisions of subsection (b).

"(b) FORM AND CONTENTS OF RETURNS.—The returns required by subsection (a) shall be in such form and shall set forth, in respect of the foreign trust, such information as the Secretary or his delegate prescribes by regulation as necessary for carrying out the provisions of the income tax laws.

"(c) CROSS REFERENCES.—

"(1) For provisions relating to penalties for violations of this section, see sections 6677 and 7203.

"(2) For definition of the term "foreign trust created by a United States person', see section 643(d)."

(g) FAILURE TO FILE INFORMATION RETURNS.—Subchapter B of chapter 68 (relating to assessable penalties) is amended by adding at the end thereof the following new section:

"SEC. 6677. FAILURE TO FILE INFORMATION RETURNS WITH RESPECT TO CERTAIN FOREIGN TRUSTS.

"(a) CIVIL PENALTY.—In addition to any criminal penalty provided by law, any person required to file a return under section 6047 who fails to file such return at the time provided in such section, or who files a return which does not show the information required pursuant to such section, shall pay a penalty equal to 5 percent of the amount transferred to a trust, but not more than $1,000, unless it is shown that such failure is due to reasonable cause.

"(b) DEFICIENCY PROCEDURES NOT TO APPLY.—Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, and gift taxes) shall not apply in respect to the assessment or collection of any penalty imposed by subsection (a)."

(h) UNITED STATES PERSON DEFINED.—Section 7701(a) is amended by adding at the end thereof the following new paragraphs:

"(30) UNITED STATES PERSON.—The term 'United States person' means—

"(A) a citizen or resident of the United States,

"(B) a domestic partnership,

"(C) a domestic corporation, and

"(D) any estate or trust (other than a foreign estate or foreign trust, within the meaning of section 7701(a)(31)).

"(31) FOREIGN ESTATE OR TRUST.—The terms 'foreign estate' and 'foreign trust' mean an estate or trust, as the case may be, the income of which from sources without the United States is not includible in gross income under subtitle A."

(i) TECHNICAL AMENDMENTS.—

(1) The table of sections for subpart D of subchapter J of chapter 1 (relating to treatment of excess distributions by trusts) is amended by adding at the end thereof

"Sec. 669. Special rules applicable to certain foreign trusts."

(2) The table of sections for subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by adding at the end thereof

"Sec. 6047. Returns as to creation of or transfers to certain foreign trusts."

(3) The table of sections for subchapter B of chapter 68 (relating to asessable penalties) is amended by adding at the end thereof

"Sec. 6677. Failure to file information returns with respect to certain foreign trusts."

(j) EFFECTIVE DATE.—The amendments made by this section (other than by subsections (f), (g), and (h)) shall apply with respect to distributions made in taxable years of trusts beginning after the date of the enactment of this Act.

SEC. 10. MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE INSURANCE COMPANIES), ETC.

(a) IMPOSITION OF TAX.—So much of part II of subchapter L (relating to mutual insurance companies, other than life or marine or fire insurance companies issuing perpetual policies) of chapter 1 as precedes section 822 is amended to read as follows:

"PART II—MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE AND CERTAIN MARINE INSURANCE COMPANIES AND OTHER THAN FIRE INSURANCE COMPANIES WHICH OPERATE ON BASIS OF PERPETUAL POLICIES OR PREMIUM DEPOSITS)

"Sec. 821. Tax on mutual insurance companies to which part II applies.
"Sec. 822. Determination of taxable investment income.
"Sec. 823. Determination of statutory underwriting income or loss.
"Sec. 824. Adjustments to provide protection against losses.
"Sec. 825. Unused loss deduction.
"Sec. 826. Election by reciprocal.

"SEC. 821. TAX ON MUTUAL INSURANCE COMPANIES TO WHICH PART II APPLIES.

"(a) IMPOSITION OF TAX.—A tax is hereby imposed for each taxable year beginning after December 31, 1962, on the mutual insurance company taxable income of every mutual insurance company (other than a life insurance com-

pany and other than a fire or marine insurance company subject to the tax imposed by section 831). Such tax shall consist of—

"(1) NORMAL TAX.—A normal tax of 25 percent of the mutual insurance company taxable income, or 50 percent of the amount by which such taxable income exceeds $6,000, whichever is the lesser; plus

"(2) SURTAX.—A surtax of 22 percent of the mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000.

"(b) MUTUAL INSURANCE COMPANY TAXABLE INCOME DEFINED.—For purposes of this part, the term 'mutual insurance company taxable income' means, with respect to any taxable year, the amount by which—

"(1) the sum of—

"(A) the taxable investment income (as defined in section 822(a)(1)),

"(B) the statutory underwriting income (as defined in section 823(a)(1)), and

"(C) the amounts required by section 824(d) to be deducted from the protection against loss account, exceeds

"(2) the sum of—

"(A) the investment loss (as defined in section 822(a)(2)),

"(B) the statutory underwriting loss (as defined in section 823(a)(2)), and

"(C) the unused loss deduction provided by section 825(a).

"(c) ALTERNATE TAX FOR CERTAIN SMALL COMPANIES.—

"(1) IMPOSITION OF TAX.—In the case of taxable years beginning after December 31, 1962, there is hereby imposed for each taxable year on the income of each mutual insurance company to which this subsection applies a tax (which shall be in lieu of the tax imposed by subsection (a)) computed as follows:

"(A) NORMAL TAX.—A normal tax of 25 percent of the taxable investment income, or 50 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser; plus

"(B) SURTAX.—A surtax of 22 percent of the taxable investment income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000.

"(2) GROSS AMOUNT RECEIVED, OVER $75,000 BUT LESS THAN $125,000.—If the gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is over $75,000 but less than $125,000, the tax imposed by paragraph (1) shall be reduced to an amount which bears the same proportion to the amount of the tax determined under paragraph (1) as the excess over $75,000 of such gross amount received bears to $50,000.

"(3) COMPANIES TO WHICH SUBSECTION APPLIES.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), this subsection shall apply to every mutual insurance company (other than a life insurance company and other than a fire or marine insurance company subject to the tax imposed by section 831) which received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) a gross amount in excess of $75,000 but not in excess of $300,000.

"(B) EXCEPTIONS.—This subsection shall not apply to a mutual insurance company for the taxable year if—

"(i) there is in effect an election by such company made under subsection (d) to be taxable under subsection (a); or

"(ii) there is any amount in the protection against loss account at the beginning of the taxable year.

"(d) ELECTION TO INCLUDE STATUTORY UNDERWRITING INCOME OR LOSS.—

"(1) IN GENERAL.—Any mutual insurance company which is subject to the tax imposed by subsection (c) may elect, in such manner and at such time as the Secretary or his delegate may by regulations prescribe, to be subject to the tax imposed by subsection (a).

"(2) EFFECT OF ELECTION.—If an election is made under paragraph (1), the electing company shall be subject to the tax imposed by subsection (a) (and shall not be subject to the tax imposed by subsection (c)) for the first taxable year for which such election is made and for all taxable years there-

after unless the Secretary or his delegate consents to a revocation of such election.

"(e) NO UNITED STATES INSURANCE BUSINESS.—Foreign mutual insurance companies (other than a life insurance company and other than a fire or marine insurance company subject to the tax imposed by section 831) not carrying on an insurance business within the United States shall not be subject to this part but shall be taxable as other foreign corporations.

"(f) CROSS REFERENCES.—

"(1) For exemption from tax of certain mutual insurance companies, see section 501(c)(15).

"(2) For alternative tax in case of capital gains, see section 1201(a)."

(b) TAXABLE INVESTMENT INCOME.—

(1) IN GENERAL.—Section 822 (relating to determination of mutual insurance company taxable income) is amended by striking out the heading and subsection (a) and inserting in lieu thereof the following:

"SEC. 822. DETERMINATION OF TAXABLE INVESTMENT INCOME.

"(a) DEFINITIONS.—For purposes of this part—

"(1) The term 'taxable investment income' means the gross investment income, minus the deductions provided in subsection (c).

"(2) The term 'investment loss' means the amount by which the deductions provided in subsection (c) exceed the gross investment income."

(2) CONFORMING AMENDMENTS.—Subsections (c) and (e) of section 822 are each amended by striking out "mutual insurance company taxable income" each place it appears and inserting in lieu thereof "taxable investment income".

(3) DIVIDENDS RECEIVED DEDUCTION.—Section 822(c)(7) (relating to special deductions) is amended by adding at the end thereof the following new sentence: "In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of this paragraph, the reference in such section to 'taxable income' shall be treated as a reference to 'taxable investment income'."

(4) REDESIGNATION OF SECTION 823.—Part II of subchapter L of chapter 1 is amended by striking out

"SEC. 823. OTHER DEFINITIONS.

"For purposes of this part—",

and inserting in lieu thereof (at the end of section 822) the following:

"(f) DEFINITIONS.—For purposes of this part—".

(c) STATUTORY UNDERWRITING INCOME OR LOSS.—Part II of subchapter L of chapter 1 is amended by adding after section 822(f) (as redesignated by subsection (b)(4) of this section) the following new sections:

"SEC. 823. DETERMINATION OF STATUTORY UNDERWRITING INCOME OR LOSS.

"(a) IN GENERAL.—For purposes of this part—

"(1) The term 'statutory underwriting income' means the amount by which—

"(A) the gross income which would be taken into account in computing taxable income under section 832 if the taxpayer were subject to the tax imposed by section 831, reduced by the gross investment income, exceeds

"(B) the sum of (i) the deductions which would be taken into account in computing taxable income if the taxpayer were subject to the tax imposed by section 831, reduced by the deductions provided in section 822(c), plus (ii) the deductions provided in subsection (c) and section 824(a).

"(2) The term 'statutory underwriting loss' means the exces of the amount referred to in paragraph (1)(B) over the amount referred to in paragraph (1)(A).

"(b) MODIFICATIONS.—In applying subsection (a)—

"(1) NET OPERATING LOSS DEDUCTION.—The deduction for net operating losses provided in section 172 shall not be allowed.

"(2) INTERINSURERS.—In the case of a mutual insurance company which is an interinsurer or reciprocal underwriter—

"(A) there shall be allowed as a deduction the increase for the taxable year in savings credited to subscriber accounts, or

"(B) there shall be included as an item of gross income the decrease for the taxable year in savings credited to subscriber accounts.

For purposes of the preceding sentence, the term 'savings credited to subscriber accounts' means such portion of the surplus as is credited to the individual acounts of subscribers before the 16th day of the third month following the close of the taxable year, but only if the company would be obligated to pay such amount promptly to such subscriber if he terminated his contract at the close of the company's taxable year. For purposes of determining his taxable income, the subscriber shall treat any such savings credited to his account as a dividend paid or declared.

"(c) SPECIAL DEDUCTION FOR SMALL COMPANY HAVING GROSS AMOUNT OF LESS THAN $900,000.—

"(1) IN GENERAL.—If the gross amount received during the taxable year by a taxpayer subject to the tax imposed by section 821(a) from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) does not equal or exceed $900,000, then in determining the statutory underwriting income or loss for the taxable year there shall be allowed an additional deduction of $6,000; except that if such gross amount exceeds $300,000, such additional deduction shall be equal to 1 percent of the amount by which $900,000 exceeds such gross amount.

"(2) LIMITATION.—The amount of the deduction allowed under paragraph (1) shall not exceed the statutory underwriting income for the taxable year, computed without regard to any deduction under this subsection or section 824(a).

"SEC. 824. ADJUSTMENTS TO PROVIDE PROTECTION AGAINST LOSSES.

"(a) ALLOWANCE OF DEDUCTION.—

"(1) IN GENERAL.—In determining the statutory underwriting income or loss for any taxable year there shall be allowed as a deduction the sum of—

"(A) an amount equal to 1 percent of the losses incurred during the taxable year (as determined under section 832(b)(5)), plus

"(B) an amount equal to 25 percent of the underwriting gain for the taxable year, plus

"(C) if the concentrated windstorm, etc., premium percentage for the taxable year exceeds 50 percent, an amount determined by applying so much of such percentage as exceeds 50 percent to the underwriting gain for the taxable year.

For purposes of this paragraph, the term 'underwriting gain' means statutory underwriting income, computed without any deduction under this subsection.

"(2) SPECIAL RULE FOR COMPANIES HAVING CONCENTRATED WINDSTORM, ETC., RISKS.—For purposes of paragraph (1)(C), the term 'concentrated windstorm, etc., premium percentage' means, with respect to any taxable year, the percentage obtained by dividing—

"(A) the amount of the premiums earned on insurance contracts during the taxable year (as defined in section 832(b)(4)), to the extent attributable to insuring against losses arising in any one State from windstorm, hail, flood, earthquake, or similar hazards, by

"(B) the amount of the premiums earned on insurance contracts during the taxable year (as so defined).

"(b) PROTECTION AGAINST LOSS ACCOUNT.—Each insurance company subject to the tax imposed by section 821(a) for any taxable year shall, for purposes of this part, establish and maintain a protection against loss account.

"(c) ADDITIONS TO ACCOUNT.—There shall be added to the protection against loss account for each taxable year an amount equal to the amount allowable as a deduction for the taxable year under subsection (a)(1).

"(d) SUBTRACTIONS.—

"(1) ANNUAL SUBTRACTIONS.—After applying subsection (c), there shall be subtracted for the taxable year from the protection against loss account—

"(A) first, an amount equal to the excess of the statutory underwriting loss for the taxable year over the underwriting loss (as defined in paragraph (6)) for the taxable year,

"(B) then, the amount (if any) by which—

"(i) the sum of the investment loss for such year and the underwriting loss for such year, exceeds

"(ii) the sum of the statutory underwriting income for such taxable year and the taxable investment income for such taxable year,

"(C) next (in the order in which the losses occurred), amounts equal to the unused loss carryovers to such year,

"(D) next, any amount remaining which was added to the account for the fifth preceding taxable year, minus one-half of the amount remaining in the account for such taxable year which was added by reason of subsection (a)(1)(B), and

"(E) finally, the amount by which the total amount in the account exceeds whichever of the following is the greater:

"(i) 10 percent of premiums earned on insurance contracts during the taxable year (as defined in section 832(b)(4)) less dividends to policyholders (as defined in section 832(c)(11)), or

"(ii) the total amount in the account at the close of the preceding taxable year.

"(2) RULES FOR CEILING ON PROTECTION AGAINST LOSS ACCOUNT.—For purposes of paragraph (1)(E), the total amount in the account shall be determined—

"(A) after the application of this section without regard to paragraph (1)(E), and

"(B) without taking into consideration amounts remaining in the account which were added, with respect to all taxable years, by reason of subsection (a)(1)(C).

"(3) PRIORITIES.—The amounts required to be substracted from the protection against loss account—

"(A) under subparagraphs (A), (B), and (C) of paragraph (1) shall be substracted—

"(i) first (on a first-in, first-out, basis) from amounts in the account with respect to the five preceding taxable years and the taxable year, and

"(ii) then from amounts in the account with respect to earlier years,

"(B) under subparagraph (E) of paragraph (1) shall be subtracted only from amounts in the account with respect to the taxable year, and

"(C) under paragraphs (A), (B), and (C), and (E) of paragraph (1) shall, if the amount to be subtracted from the total amounts in the account with respect to any taxable year is less than such total, be subtracted from each of the amounts (referred to in subsection (a)(1)) in the account with respect to such year in the proportion which each bears to such total.

"(4) TERMINATION OF TAXABILITY UNDER SECTION 821.—If the taxpayer is not subject to tax under section 821 for any taxable year, the entire amount in the account at the close of the preceding taxable year shall be subtracted from the account in such preceding taxable year.

"(5) ELECTION TO SUBTRACT AMOUNT FROM ACCOUNT.—

"(A) A taxpayer may elect for any taxable year for which it is subject to tax under section 821(a) to subtract from its protection against loss account any amount which, but for the application of this subparagraph, would be in such account as of the close of such taxable year.

"(B) The election provided by subparagraph (A) for any taxable year shall be made (in such manner and in such form as the Secretary or his delegate may by regulations prescribe) after the close of such taxable year and not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year following such taxable year. Such an election, once made, may not be revoked.

"(6) UNDERWRITING LOSS DEFINED.—For purposes of paragraph (1), the term 'underwriting loss' means the amount by which—

"(A) the deductions which would be taken into account in computing taxable income under section 832 if the taxpayer were subject to the tax imposed by section 831, reduced by the sum of (i) the deductions provided in section 822(c), and (ii) the deduction for dividends to policyholders provided by section 832(c)(11), exceeds

"(B) the amount referred to in section 823(a)(1)(A).

"SEC. 825. UNUSED LOSS DEDUCTION.

"(a) AMOUNT OF DEDUCTION.—For purposes of this part, the unused loss deduction for the taxable year shall be an amount equal to the unused loss carryovers or carrybacks to the taxable year.

"(b) UNUSED LOSS DEFINED.—For purposes of this part, the term 'unused loss' means, with respect to any taxable year, the amount (if any) by which—

"(1) the sum of the statutory underwriting loss and the investment loss, exceeds

"(2) the sum of—

"(A) the taxable investment income,

"(B) the statutory underwriting income, and

"(C) the amounts required by section 824(d) to be subtracted from the protection against loss account.

"(c) LOSS YEAR DEFINED.—For purposes of this part, the term 'loss year' means, with respect to any company subject to the tax imposed by section 821(a), any taxable year in which the unused loss (as defined in subsection (b)) of such taxpayer is more than zero.

"(d) YEARS TO WHICH CARRIED.—The unused loss for any loss year shall be—

"(1) an unused loss carryback to each of the 3 taxable years preceding the loss year, and

"(2) an unused loss carryover to each of the 5 taxable years following the loss year.

"(e) AMOUNT OF CARRYBACKS AND CARRYOVERS.—The entire amount of the unused loss for any loss year shall be carried to the earliest of the taxable years to which such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess (if any) of the amount of such loss over the sum of the offsets (as defined in subsection (f)) for each of the prior taxable years to which such loss may be carried.

"(f) OFFSET DEFINED.—For purposes of subsection (e), the term 'offset' means with respect to any taxable year (hereinafter referred to as the 'offset year')—

"(1) in the case of an unused loss carryback from the loss year to the offset year, the mutual insurance company taxable income for the offset year; or

"(2) in the case of an unused loss carryover from the loss year to the offset year, an amount equal to the sum of—

"(A) the amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) for the offset year, plus

"(B) the mutual insurance company taxable income for the offset year.

For purposes of paragraphs (1) and (2)(B), the mutual insurance taxable income for the offset year shall be determined without regard to any unused loss carryback or carryover from the loss year or any taxable year thereafter.

"(g) LIMITATIONS.—For purpose of this part, an unused loss shall not be carried—

"(1) to or from any taxable year beginning before January 1, 1963,

"(2) to or from any taxable year for which the insurance company is not subject to the tax imposed by section 821(a), nor

"(3) to any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 821(a).

"SEC. 826. ELECTION BY RECIPROCAL.

"(a) IN GENERAL.—Except as otherwise provided in this section, any mutual insurance comapny which is an interinsurer or reciprocal underwriter (hereinafter in this section referred to as a 'reciprocal') subject to the taxes imposed by section 821(a) may, under regulations prescribed by the Secretary or his delegate, elect to be subject to the limitation provided in subsection (b). Such election shall be effective for the taxable year for which made and for all succeeding taxable years, and shall not be revoked except with the consent of the Secretary or his delegate.

"(b) LIMITATION.—The deduction for amounts paid or incurred in the taxable year to the attorney-in-fact by a reciprocal making the election provided in subsection (a) shall be limited to, but in no case increased by, the deductions of the attorney-in-fact allocable, in accordance with regulations prescribed by the Secretary or his delegate, to the income received by the attorney-in-fact from the reciprocal.

"(c) EXCEPTION.—An election may not be made by a reciprocal under subsection (a) unless the attorney-in-fact of such reciprocal—

"(1) is subject to the taxes imposed by section 11(b) and (c);

"(2) consents in such manner as the Secretary or his delegate shall prescribe by regulations to make available such information as may be

required during the period in which the election provided in subsection (a) is in effect, under regulations prescribed by the Secretary or his delegate;

"(3) reports the income received from the reciprocal and the deductions allocable thereto under the same method of accounting under which the reciprocal reports deductions for amounts paid to the attorney-in-fact; and

"(4) files its return on the calendar year basis.

"(d) SPECIAL RULE.—For purposes of computing the deduction provided in section 824(a) and the additions to the account provided by section 824(c) with respect to any reciprocal electing to be subject to the limitation provided in subsection (b), such limitation shall not be taken into account.

"(e) CREDIT.—Any reciprocal electing to be subject to the limitation provided in subsection (b) shall be credited with so much of the tax paid by the attorney-in-fact as is attributable, under regulations prescribed by the Secretary or his delegate, to the income received by the attorney-in-fact from the reciprocal in such taxable year.

"(f) SURTAX EXEMPTION DENIED.—Any increase in taxable income of a reciprocal attributable to the limitation provided in subsection (b) shall be taxed without regard to the surtax exemption provided in section 821(a)(2).

"(g) ADJUSTMENT FOR REFUND.—If for any taxable year an attorney-in-fact is allowed a credit or refund for taxes paid with respect to which a reciprocal was allowed a credit under subsection (e), the taxes of such reciprocal for such taxable year shall be properly adjusted under regulations prescribed by the Secretary or his delegate.

"(h) TAXES OF ATTORNEY-IN-FACT UNAFFECTED.—Nothing in this section shall increase or decrease the taxes imposed by this chapter on the income of the attorney-in-fact."

(d) MUTUAL FIRE INSURANCE COMPANIES OPERATING ON BASIS OF PREMIUM DEPOSITS.—

(1) APPLICATION OF SECTION 831(a).—Section 831(a) (imposing a tax on certain mutual marine and fire insurance companies and on stock insurance companies which are not life insurance companies) is amended to read as follows:

"(a) IMPOSITION OF TAX.—Taxes computed as provided in section 11 shall be imposed for each taxable year or the taxable income of—

"(1) every insurance company (other than a life or mutual insurance company),

"(2) every mutual marine insurance company, and

"(3) every mutual fire insurance company—

"(A) exclusively issuing perpetual policies, or

"(B) whose principal business is the issuance of policies for which the premium deposits are the same, regardless of the length of the term for which the policies are written, if the unabsorbed portion of such premium deposits not required for losses, expenses, or establishment of reserves is returned or credited to the policyholder on cancellation or expiration of the policy."

(2) TREATMENT OF UNABSORBED PREMIUM DEPOSITS.—Section 832(b)(4) (relating to definition of premiums earned) is amended by adding at the end thereof the following new sentence: "For purposes of this subsection, unearned premiums of mutual fire insurance companies described in section 831(a)(3)(B) means (with respect to the policies described in section 831(a)(3)(B)) the amount of unabsorbed premium deposits which the company would be obligated to return to its policyholders at the close of the taxable year if all of its policies were terminated at such time; and the determination of such amount shall be based on the schedule of unabsorbed premium deposit returns for each such company then in effect."

(3) CONFORMING AMENDMENT.—Section 832(b)(1)(C) is amended by striking out "section 831(a)," and inserting in lieu thereof "section 831(a)(3)(A),".

(4) ADJUSTMENT OF PREMIUM DEPOSIT.—Section 832(c)(11) is amended to read as follows:

"(11) dividends and similar distributions paid or declared to policyholders in their capacity as such, except in the case of a mutual fire insurance company described in section 831(a)(3)(A). For purposes of the preceding sentence, the term 'dividends and similar distributions' includes amounts returned or credited to policyholders on cancellation or expiration of policies described in section 831(a)(3)(B). For purposes of this paragraph, the

term 'paid or declared' shall be construed according to the method of accounting regularly employed in keeping the books of the insurance company; and".

(5) ADDITIONAL ITEM OF INCOME.—Section 832(b)(1) is amended by striking out "and" at the end of subparagraph (B), by striking out the period at the end of subparagraph (C) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(D) in the case of a mutual fire insurance company described in section 831(a)(3)(B), an amount equal to 2 percent of the premiums earned on insurance contracts during the taxable year with respect to policies described in section 831(a)(3)(B) after deduction of premium deposits returned or credited during the same taxable year."

(e) ELECTION OF CERTAIN MUTUAL COMPANIES TO BE TAXED ON TOTAL INCOME.—Section 831 is amended by redesignating subsection (c) as subsection (d), and by inserting after subsection (b) the following new subsection:

"(c) ELECTION FOR MULTIPLE LINE COMPANY TO BE TAXED ON TOTAL INCOME.—

"(1) IN GENERAL.—Any mutual insurance company engaged in writing marine, fire, and casualty insurance which for any 5-year period beginning after December 31, 1941, and ending before January 1, 1962, was subject to the tax imposed by section 831 (or the tax imposed by corresponding provisions of prior law) may elect, in such manner and at such time as the Secretary or his delegate may by regulations prescribe, to be subject to the tax imposed by section 831, whether or not marine insurance is its predominant source of premium income.

"(2) EFFECT OF ELECTION.—If an election is made under paragraph (1), the electing company shall (in lieu of being subject to the tax imposed by section 821) be subject to the tax imposed by this section for taxable years beginning after December 31, 1961. Such election shall not be revoked except with the consent of the Secretary or his delegate."

(f) TECHNICAL AMENDMENTS, ETC.—

(1) CREDIT FOR FOREIGN TAXES.—Section 841 (relating to credit for foreign taxes) is amended by striking out "and" at the end of paragraph (1), by renumbering paragraph (2) as paragraph (3), and by inserting after paragraph (1) the following new paragraph:

"(2) in the case of the tax imposed by section 821(a), the mutual insurance company taxable income (as defined in section 821(b)); and in the case of the tax imposed by section 821(c), the taxable investment income (as defined in section 822(a)), and".

(2) ADJUSTMENTS TO BASIS FOR DEPRECIATION SUSTAINED.—Section 1016(a)(3) (relating to adjustments to basis for depreciation, etc., sustained) is amended by striking out "and" at the end of subparagraph (B), and by inserting after subparagraph (C) the following new subparagraph:

"(D) since February 28, 1913, during which such property was held by a person subject to tax under part II of subchapter L (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply,".

(3) ALTERNATIVE TAX ON CAPITAL GAINS.—Section 1201(a) (relating to alternative tax on corporations) is amended by striking out "821 (a)(1) or (b)" and inserting in lieu thereof "821 (a) or (c),".

(4) CLERICAL AMENDMENT.—The table of parts for subchapter L is amended by striking out the portion referring to part II and inserting in lieu thereof the following:

"Part II. Mutual insurance companies (other than life and certain marine insurance companies and other than fire insurance companies which operate on basis of perpetual policies or premium deposits)."

(g) EFFECTIVE DATE.—The amendments made by this section (other than by subsection (e)) shall apply with respect to taxable years beginning after December 31, 1962.

SEC. 11. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS.

(a) ENTIRE AMOUNT OF FOREIGN TAX TO BE TAKEN INTO ACCOUNT.—

(1) DEFINITION OF ACCUMULATED PROFITS.—So much of paragraph (1) of section 902(c) (relating to applicable rules for computing credit for corporate stockholder in foreign corporation) as precedes the semicolon is amended to read as follows:

"(1) The term 'accumulated profits', when used in this section in reference to a foreign corporation, means the amount of its gains, profits, or income

computed without reduction by the amount of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income by any foreign country or any possession of the United States".

(2) CONFORMING AMENDMENTS.—

(A) Section 902(a) is amended by striking out "which the amount of such dividends bears to the amount of such accumulated profits" and inserting in lieu thereof "which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid)".

(B) Section 902(b) is amended by striking out "which the amount of such dividends bears to the amount of such accumulated profits" and inserting in lieu thereof "which the amount of such dividends bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes".

(b) INCLUSION IN GROSS INCOME OF AMOUNT EQUAL TO TAXES DEEMED PAID.—Part II of subchapter B of chapter I (relating to items specifically included in gross income) is amended by adding at the end thereof the following new section:

"SEC. 78. DIVIDENDS RECEIVED FROM FOREIGN CORPORATIONS BY DOMESTIC CORPORATIONS CHOOSING FOREIGN TAX CREDIT.

"If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under section 902 (relating to credit for corporate stockholder in foreign corporation) or under section 957(a) (relating to taxes paid by foreign corporation) for such taxable year shall be treated for purposes of this title (other than section 245) as a dividend received by such domestic corporation from the foreign corporation."

(c) DETERMINATION OF SOURCE OF DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS.—Section 861(a)(2)(B) (relating to dividends from foreign corporations treated as income from sources within the United States) is amended by striking out "to the extent exceeding the amount of the deduction allowable under section 245 in respect of such dividends" and inserting in lieu thereof "to the extent exceeding the amount which is 100/85th of the amount of the deduction allowable under section 245 in respect of such dividends".

(d) REPEAL OF SECTION 902(d).—Subsection (d) (relating to special rules for certain wholly owned foreign corporations) is hereby repealed.

(e) TECHNICAL AMENDMENTS.—

(1) The table of sections for part II of subchapter B of chapter 1 is amended by adding at the end thereof the following:

"Sec. 78. Dividends received from foreign corporations by domestic corporations choosing foreign tax credit."

(2) Section 535(b)(1) and the first sentence of section 545(b)(1) are each amended by striking out "accrued during the taxable year," and inserting in lieu thereof "accrued during the taxable year or deemed to be paid by a domestic corporation under section 902 for the taxable year,".

(3) Section 901(d) is amended by adding the following new paragraph:

"(4) For reduction of credit for failure of a United States person to furnish certain information with respect to a foreign corporation controlled by him, see section 6038."

(4) Section 902 is amended by striking out subsection (e) and inserting in lieu thereof the following:

"(d) CROSS REFERENCES.—

"(1) For inclusion in gross income of an amount equal to taxes deemed paid under this section, see section 78.

"(2) For reduction of credit with respect to dividends paid out of accumulated profits for years for which certain information is not furnished, see section 6038."

(f) EFFECTIVE DATE.—The amendments made by this section shall apply—

(1) in respect of any distribution received by a domestic corporation after December 31, 1964, and

(2) in respect of any distribution received by a domestic corporation before January 1, 1965, in a taxable year of such corporation beginning after December 31, 1962, but only to the extent that such distribution is made out of the accumulated profits of a foreign corporation for a taxable year (of such foreign corporation) beginning after December 31, 1962.

For purposes of paragraph (2), a distribution made by a foreign corporation out of its profits which are attributable to a distribution received from a foreign subsidiary to which section 902(b) applies shall be treated as made out of the accumulated profits of a foreign corporation for a taxable year beginning before January 1, 1963, to the extent that such distribution was paid out of the accumulated profits of such foreign subsidiary for a taxable year beginning before January 1, 1963.

SEC. 12. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES.

(a) LIMITATION ON AMOUNT AND TYPE OF INCOME EXCLUDED.—Section 911 (relating to earned income from sources without the United States) is amended to read as follows:

"SEC. 911. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES.

"(a) GENERAL RULE.—The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

"(1) BONA FIDE RESIDENT OF FOREIGN COUNTRY.—In the case of an individual citizen of the United States who establishes to the satisfaction of the Secretary or his delegate that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) which constitute earned income attributable to services performed during such uninterrupted period. The amount excluded under this paragraph for any taxable year shall be computed by applying the special rules contained in subsection (c).

"(2) PRESENCE IN FOREIGN COUNTRY FOR 17 MONTHS.—In the case of an individual citizen of the United States who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) which constitute earned income attributable to services performed during such 18-month period. The amount excluded under this paragraph for any taxable year shall be computed by applying the special rules contained in subsection (c).

An individual shall not be allowed, as a deduction from his gross income, any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this subsection.

"(b) DEFINITION OF EARNED INCOME.—For purposes of this section, the term 'earned income' means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income.

"(c) SPECIAL RULES.—For purposes of computing the amount excludable under subsection (a), the following rules shall apply:

"(1) LIMITATIONS ON AMOUNT OF EXCLUSION.—The amount excluded from the gross income of an individual under subsection (a) for any taxable year shall not exceed an amount which shall be computed on a daily basis at an annual rate of—

"(A) except as provided in subparagraph (B), $20,000 in the case of an individual who qualifies under subsection (a), or

"(B) $35,000 in the case of an individual who qualifies under subsection (a)(1), but only with respect to that portion of such taxable year occurring after such individual has been a bona fide resident of a foreign country or countries for an uninterrupted period of 3 consecutive years.

"(2) ATTRIBUTION TO YEAR IN WHICH SERVICES ARE PERFORMED.—For purposes of applying paragraph (1), amounts received shall be considered received in the taxable year in which the services to which the amounts are attributable are performed.

"(3) TREATMENT OF COMMUNITY INCOME.—In applying paragraph (1) with respect to amounts received for services performed by a husband or wife which are community income under community property laws applicable to such income, the aggregate amount excludable under subsection (a) from the gross income of such husband and wife shall equal the amount which would be excludable if such amounts did not constitute such community income.

"(4) REQUIREMENT AS TO TIME OF RECEIPT.—No amount received after the close of the taxable year following the taxable year in which the services to which the amounts are attributable are performed may be excluded under subsection (a).

"(5) CERTAIN AMOUNTS NOT EXCLUDABLE.—No amount—

"(A) received as a pension or annuity, or

"(B) included in gross income by reason of section 402(b) (relating to taxability of beneficiary of non-exempt trust), section 403(c) (relating to taxability of beneficiary under a non-qualified annuity), or section 400(d) (relating to taxability of beneficiary under certain forfeitable contracts purchased by exempt organizations),

may be excluded under subsection (a).

"(d) CROSS REFERENCES.—

"For administrative and penal provisions relating to the exclusion provided for in this section, see sections 6001, 6011, 6012(c), and the other provisions of subtitle F."

(b) COMPUTATION OF EMPLOYEES' CONTRIBUTIONS.—Section 72(f) (relating to special rules for computing employees' contributions) is amended by adding after paragraph (2) the following new sentences:

"Paragraph (2) shall not apply to amounts which were contributed by the employer after December 31, 1962, and which would not have been includible in the gross income of the employee by reason of the application of section 911 if such amounts had been paid directly to the employee at the time of contribution. The preceding sentence shall not apply to amounts which were contributed by the employer, as determined under regulations prescribed by the Secretary or his delegate, to provide pension or annuity credits, to the extent such credits are attributable to services performed before January 1, 1963, and are provided pursuant to pension or annuity plan provisions in existence on March 12, 1962, and on that date applicable to such services."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years ending after December 31, 1962.

(2) AMENDMENTS TO SECTION 911.—The amendment made by subsection (a) shall apply only with respect to amounts received after December 31, 1962, and which are attributable either to—

(A) services performed after such date, or

(B) services performed on or before such date, but only if on March 12, 1962, there existed no right (whether forfeitable or nonforfeitable) to receive such amounts.

SEC. 13. CONTROLLED FOREIGN CORPORATIONS.

(a) IN GENERAL.—Part III of subchapter N of chapter 1 (relating to income from sources without the United States) is amended by adding at the end thereof the following new subpart:

"Subpart F—Controlled Foreign Corporations

"Sec. 951. Amounts included in gross income of United States persons.
"Sec. 952. Subpart F income defined.
"Sec. 953. Investment of earnings in nonqualified property.
"Sec. 954. Controlled foreign corporations.
"Sec. 955. Rules for determining stock ownership.
"Sec. 956. Exclusion from gross income of previously taxed earnings and profits.
"Sec. 957. Special rules for foreign tax credit.
"Sec. 958. Adjustments to basis of stock in controlled foreign corporations and of other property.

"SEC. 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES PERSONS.

"(a) AMOUNTS INCLUDED.—

"(1) IN GENERAL.—If a foreign corporation is a controlled corporation on any day of a taxable year beginning after December 31, 1962, every United

States person (as defined in section 7701(a)(30)) who owns (within the meaning of section 955(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—

"(A) his pro rata share (determined under paragraph (2) of the corporation's subpart F income for such year, and

"(B) his pro rata share (determined under section 953(a)(2)) of the corporation's increase in earnings invested in nonqualified property for such year (but only to the extent not excluded from gross income under section 956(a)(2)).

"(2) PRO RATA SHARE OF SUBPART F INCOME.—The pro rata share referred to in paragraph (1)(A) in the case of any United States person is the amount—

"(A) which would have been distributed with respect to the stock which such person owns (within the meaning of section 955(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by

"(B) the amount of any distribution received by any other United States person during such year as a dividend with respect to such stock.

"(3) LIMITATION ON AMOUNT OF PRO RATA SHARE OF INVESTMENT IN NONQUALIFIED PROPERTY INCLUDED IN GROSS INCOME.—For purposes of paragraph (1)(B), the pro rata share of any United States person in the increase of the earnings of a controlled foreign corporation invested in nonqualified property shall not exceed an amount (A) which bears the same ratio to his pro rata share of such increase (as determined under section 953(a)(2)) for the taxable year, as (B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

"(b) LESS THAN 10-PERCENT OWNERSHIP.—No person shall be required to include any amount in gross income under subsection (a) unless he can be considered, by applying the rules of ownership of section 955(b), as owning, directly or indirectly, on any day during the taxable year of the corporation on which it was a controlled foreign corporation, 10 percent or more of the total combined voting power of all classes of stock, or of the total value of shares of all classes of stock, of such corporation.

"(c) COORDINATION WITH ELECTION OF A FOREIGN INVESTMENT COMPANY TO DISTRIBUTE INCOME.—A United States person who, for his taxable year, is a qualified shareholder (within the meaning of section 1247(c)) of a foreign investment company with respect to which an election under section 1247 is in effect shall not be required to include in gross income, for such taxable year, subpart F income of such company.

"SEC. 952. SUBPART F INCOME DEFINED.

"(a) IN GENERAL.—

"(1) ITEMS TAKEN INTO ACCOUNT.—For purposes of this subpart, the term 'subpart F income' means, in the case of any controlled foreign corporation, the sum of—

"(A) income derived from insurance of United States risks (as determined under subsection (b)),

"(B) income from United States patents, copyrights, and exclusive formulas and processes (as determined under subsection (c)), and

"(C) the net foreign base company income (as determined under subsection (d)), except that this subparagraph shall apply only in the case of a controlled foreign corporation in which 5 or fewer United States persons own, by applying the rules of ownership of section 955(b), more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

"(2) EXCLUSION OF UNITED STATES INCOME.—Subpart F income does not include any item includible in gross income under this chapter (other than this subpart) as income derived from sources within the United States of a foreign corporation engaged in trade or business in the United States.

"(3) NOT TO EXCEED EARNINGS AND PROFITS.—The subpart F income of any controlled foreign corporation for any taxable year shall not exceed the earnings and profits of such corporation for such year.

"(b) INCOME FROM INSURANCE OF UNITED STATES RISKS.—

"(1) GENERAL RULE.—If a controlled foreign corporation receives premiums or other consideration in respect of any reinsurance or the issuing of any insurance or annuity contract—

"(A) in connection with property in, or residents of, the United States, or

"(B) in connection with property not in, or nonresidents of, the United States as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of any reinsurance or the issing of any insurance or annuity contract in connection with property in, or residents of, the United States,

then for purposes of subsection (a)(1)(A), the term 'income derived from the insurance of United States risks' means that income which (subject to the modifications provided by subparagraphs (A), (B), and (C) of paragraph (2)) would be taxed under subchapter L of this chapter if such corporation were a domestic corporation.

"(2) SPECIAL RULES.—For purposes of paragraph (1)—

"(A) In the application of part I of subchapter L, life insurance company taxable income is the gain from operations as defined in section 809(b).

"(B) A corporation which would, if it were a domestic corporation, be taxable under part II of subchapter L shall apply paragraph (1) as if it were taxable under part III of subchapter L.

"(C) The following provisions of subchapter L shall not apply:

"(i) Section 809(d)(4) (operations loss deduction).

"(ii) Section 809(d)(5) (certain nonparticipating contracts).

"(iii) Section 809(d)(6) (group life, accident, and health insurance).

"(iv) Section 809(d)(10) (small business deduction).

"(v) Section 817(b) (gain on property held on December 31, 1958, and certain substituted property acquired after 1958).

"(vi) Section 832(b)(5) (certain capital losses).

"(D) 'Gross amount' to the extent provided in section 809(c) (1) and (2), less 'increase in certain reserves' as defined in section 809 (d)(2), and 'premiums earned' as defined in section 832(b)(4) shall be taken into account only to the extent they are in respect of any reinsurance or the issuing of any reinsurance or the issuing of any insurance or annuity contract described in paragraph (1).

"(E) All items of income (other than those taken into account under subparagraph (D)) and all items of expenses, losses, and deductions shall be properly allocated or apportioned under regulations prescribed by the Secretary or his delegate.

"(c) INCOME FROM UNITED STATES PATENTS, COPYRIGHTS, AND EXCLUSIVE FORMULAS AND PROCESSES.—

"(1) GENERAL RULE.—For purposes of subsection (a)(1)(B), the term 'income from United States patents, copyrights, and exclusive formulas and processes', means the amount of gross rentals, royalties, or other income derived from the license, sublicense, sale, exchange, use, or other means of exploitation of patents, copyrights, and exclusive formulas and processes—

"(A) substantially developed, created, or produced in the United States, or

"(B) acquired from any United States person which, directly or indirectly, owns or controls, or is owned or controlled by, or is under common ownership or control with, the controlled foreign corporation,

less the cost and expense allowance defined in paragraph (2).

"(2) COST AND EXPENSE ALLOWANCE.—An allowance shall be made, in accordance with regulations prescribed by the Secretary or his delegate, for ordinary and necessary expenses incurred by the controlled foreign corporation in the receipt or production of the income described in paragraph (1), including taxes and any amortization or depreciation of the cost to such corporation of such property or rights described in paragraph (1), but not

including any production, manufacturing, or similar expenses incurred in the use or other means of exploitation of such property or rights.

"(3) DETERMINATION OF INCOME FROM USE.—The income from use or other means of exploitation by the controlled foreign corporation of the property or right described in paragraph (1) shall be the amount which would be obtained as a gross rent, royalty, or other payment in an arm's length transaction with an unrelated person for similar use or exploitation, of the property or right.

"(d) NET FOREIGN BASE COMPANY INCOME.—For purposes of subsection (a)(1)(C), the term 'net foreign base company income' means—

"(1) the foreign base company income for the taxable year, determined under subsection (e), reduced by

"(2) the increase in investment in qualified property in less developed countries for the taxable year, determined under subsection (f).

"(e) FOREIGN BASE COMPANY INCOME.—

"(1) IN GENERAL.—For purposes of subsection (d)(1), the term 'foreign base company income' means the foreign personal holding company income (as defined in section 553) for the taxable year, modified and adjusted as provided in this subsection.

"(2) CERTAIN SALES INCOME INCLUDED.—The term 'foreign base company income' includes foreign base company sales income if, for the taxable year, such income is equal to at least 20 percent of the gross income of the foreign corporation (not including for this purpose other foreign base company income under this subsection). For purposes of this paragraph, the term 'foreign base company sales income' means income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, or the purchase of personal property from any person and its sale to a related person, where—

"(A) the property which is purchased is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and

"(B) the property is sold for use, consumption, or disposition outside such foreign country.

For purposes of the preceding sentence, a person is a related person with respect to the controlled foreign corporation if he, directly or indirectly, owns or controls, or is owned or controlled by, or is under common ownership or control with, the controlled foreign corporation.

"(3) RENTS INCLUDED WITHOUT REGARD TO 50-PERCENT LIMITATION.—All rents shall be included in foreign base company income without regard to whether or not such rents constitute more than 50 percent of gross income.

"(4) INSURANCE AND PATENT INCOME EXCLUDED.—The term 'foreign base company income' does not include any income derived from insurance of United States risks (as determined under subsection (b)) or income from United States patents, copyrights, and exclusive formulas and processes (as determined under subsection (c)).

"(5) INCOME OF CERTAIN BANKS AND BANK-CONTROLLED CORPORATIONS EXCLUDED.—The term 'foreign base company income' does not include—

"(A) the income of any corporation described in section 552(b) (relating to exception for banks and exempt corporations), or

"(B) the income of any foreign corporation if 50 percent or more of the fair market value of its outstanding stock is owned directly or indirectly by a domestic corporation which is either organized under section 25(a) of the Federal Reserve Act (12 U.S.C., secs. 611–631), or has an agreement or understanding with the Board of Governors of the Federal Reserve System under section 25 of the Federal Reserve Act (12 U.S.C., secs. 601–604), if all of the stock (except qualifying shares) of the domestic corporation is owned by a national or State bank which is a member of the Federal Reserve System.

"(6) SPECIAL RULE WHERE FOREIGN BASE COMPANY INCOME IS LESS THAN 20 PERCENT OR MORE THAN 80 PERCENT OF GROSS INCOME.—For purposes of this subsection—

"(A) If the foreign base company income (determined without regard to paragraph (7)) is less than 20 percent of gross income, no part of the gross income of the taxable year shall be treated as foreign base company income.

"(B) If the foreign base company income (determined without regard to paragraph (7)) exceeds 80 percent of gross income, the entire gross income of the taxable year shall be taken into account in determining foreign base company income.

"(7) DEDUCTIONS TO BE TAKEN INTO ACCOUNT.—The foreign base company income for the taxable year shall be reduced so as to take into account deductions (including taxes) properly allocable to such income.

"(f) INVESTMENT IN QUALIFIED PROPERTY IN LESS DEVELOPED COUNTRIES.—

"(1) GENERAL RULE.—For purposes of subsection (d)(2), the increase in investment in qualified property in less developed countries for any taxable year is the amount by which—

"(A) the aggregate amount of property described in section 953(b)(2)(C) and (D) and property (including money) which is located outside the United States and is ordinary and necessary for the active conduct of a qualified trade or business described in section 953(b)(3)(A)(ii) held at the close of the taxable year, exceeds

"(B) the aggregate amount of property described in subparagraph (A) held at the close of the preceding taxable year.

"(2) INVESTMENTS AFTER CLOSE OF YEAR.—Under regulations prescribed by the Secretary or his delegate, a controlled foreign corporation may elect to make the determinations under subparagraphs (A) and (B) of paragraph (1) as of the close of the 75th day after the close of each taxable year.

"(3) AMOUNT ATTRIBUTABLE TO PROPERTY.—The amount taken into account under paragraph (1) with respect to any property shall be its adjusted basis, reduced by any liability to which the property is subject.

"SEC. 953. INVESTMENT OF EARNINGS IN NONQUALIFIED PROPERTY.

"(a) GENERAL RULES.—For purposes of this subpart—

"(1) AMOUNT OF INVESTMENT.—The amount of earnings of a controlled foreign corporation invested in nonqualified property at the close of any taxable year is the aggregate amount of such property held at the close of the taxable year, to the extent such amount does not exceed the sum of (A) the earnings and profits for the taxable year, and (B) the earnings and profits accumulated for prior taxable years beginning after December 31, 1962.

"(2) PRO RATA SHARE OF INCREASE FOR YEAR.—In the case of any United States person, the pro rata share of the increase for any taxable year in the earnings of a controlled foreign corporation invested in a nonqualified property is the amount determined by subtracting—

"(A) his pro rata share of the amount determined under paragraph (1) for the close of the preceding taxable year, reduced by amounts paid during the taxable year to which section 956(c)(1) applies, from

"(B) his pro rata share of the amount determined under paragraph (1) for the close of the taxable year.

"(3) AMOUNT ATTRIBUTABLE TO PROPERTY.—The amount taken into account under paragraph (1) or (2) with respect to any property shall be its adjusted basis, reduced by any liability to which the property is subject.

"(b) NONQUALIFIED PROPERTY DEFINED.—For purposes of this subpart—

"(1) GENERAL RULE.—The term 'nonqualified property' means any money or other property (tangible or intangible) acquired after December 31, 1962, which is not qualified property.

"(2) QUALIFIED PROPERTY.—The term 'qualified property' means—

"(A) Any money or other property which is located outside the United States and is ordinary and necessary for the active conduct of a qualified trade or business (as determined under paragraph (3)) carried on by the controlled foreign corporation.

"(B) Property which would qualify under subparagraph (A) except for the fact that it is located in the United States, but only if such property is—

"(i) obligations of the United States, money, or deposits with persons carrying on the banking business;

"(ii) property purchased in the United States for export to, or for use in, foreign countries; or

"(iii) any loan arising in connection with the sale of property if the amount of such loan outstanding at no time during the taxable year exceeds the amount which would be ordinary and

necessary to carry on the trade or business of both the lending corporation and the borrowing United States person had the sale been made between unrelated persons.

"(C) Stock owned by the controlled foreign corporation in another controlled foreign corporation in which it owns at least 10 percent of the voting stock and 10 percent of the value of all classes of stock and in which it together with four or fewer United States persons, owns, directly or indirectly, more than 50 percent of the voting stock (unless under the laws of a less developed country such percentage of ownership is not permitted, in which case such lesser percentage as is permitted); but this subparagraph shall apply only if—

"(i) substantially all of the property of such other controlled foreign corporation is ordinary and necessary for the active conduct of a trade or business engaged in by it almost wholly within a less developed country or countries, and

"(ii) such other controlled foreign corporation is created or organized under the laws of one of such countries in which it is so engaged.

"(D) Any investment which is required because of restrictions imposed by a less developed country, and any investment which, when made, was so required and which would result in substantial losses if withdrawn.

"(3) QUALIFIED TRADE OR BUSINESS.—

"(A) A trade or business is a qualified trade or business if such trade or business (or substantially the same trade or business)—

"(i) is carried on by the controlled foreign corporation outside the United States and has been so carried on by such corporation, while controlled by substantially the same United States persons since December 31, 1962, or during the 5-year period ending with the close of the preceding taxable year, or

"(ii) is carried on by the controlled foreign corporation almost wholly within a less developed country or countries.

"(B) A trade or business which is a qualified trade or business for a corporation in which the controlled foreign corporation owns at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total value of all classes of stock shall be treated as a qualified trade or business for the controlled foreign corporation if such percentage of stock was owned continuously since December 31, 1962, or during the 5-year period ending with the close of the preceding taxable year.

"(4) SITUS OF CERTAIN PROPERTY.—Property which is an obligation of, or pledges and guarantees made with respect to obligations of, United States persons shall be considered as property located in the United States.

"(5) LESS DEVELOPED COUNTRY DEFINED.—The term 'less developed country' means (in respect of any foreign corporation) any foreign country (other than an area within the Sino-Soviet bloc) or any possession of the United States, with respect to which on the first day of the taxable year, there is in effect an Executive order by the President of the United States designating such country or possession as an economically less developed country for purposes of this subpart. For purposes of the preceding sentence, an oversea territory, department, province, or possession may be treated as a separate country. No designation shall be made under this paragraph with respect to—

Australia
Austria
Belgium
Canada
Denmark
France
Germany (Federal Republic)
Hong Kong
Italy
Japan
Liechtenstein
Luxembourg
Monaco
Netherlands
New Zealand
Norway
Union of South Africa
San Marino
Sweden
Switzerland
United Kingdom

"SEC. 954. CONTROLLED FOREIGN CORPORATIONS.

"(a) GENERAL RULE.—For purposes of this subpart, the term 'controlled foreign corporation' means any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned, directly or indirectly (within the meaning of section 955(b)), by United States persons on any day during the taxable year of such foreign corporation.

"(b) SPECIAL RULE FOR INSURANCE.—For purposes only of taking into account income described in section 952(a)(1)(A) (relating to income derived from insurance of United States risks), the term 'controlled foreign corporation' includes not only a foreign corporation as defined by subsection (a) but also one of which more than 25 percent of the total combined voting power of all classes of stock is owned, directly or indirectly (within the meaning of section 955(b)), by United States persons on any day during the taxable year of such corporation, if the gross amount of premiums or other consideration in respect of reinsurance or the issuing of insurance or annuity contracts in connection with property in, or residents of, the United States, exceeds 75 percent of the gross amount of all premiums or other consideration in respect of all risks.

"(c) SPECIAL RULE FOR CERTAIN LESS DEVELOPED COUNTRIES.—In the case of any foreign corporation to which section 953(b)(2)(C) applies, the maximum percentage of ownership permitted under the laws of a less developed country shall be considered, in lieu of the more than 50 percent requirement in subsection (a), the percentage required under subsection (a) in order for the corporation to be classified as a controlled foreign corporation.

"SEC. 955. RULES FOR DETERMINING STOCK OWNERSHIP.

"(a) FOR PURPOSES OF SECTION 951(a).—

"(1) GENERAL RULE.—For purposes of section 951(a), stock owned means—

"(A) stock owned directly, and

"(B) stock owned with the application of paragraph (2).

"(2) STOCK OWNERSHIP THROUGH FOREIGN ENTITIES.—For purposes of subparagraph (B) of paragraph (1), stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.

"(3) SPECIAL RULE FOR MUTUAL INSURANCE COMPANIES.—For purposes of applying paragraph (1) in the case of a foreign mutual insurance company, the term 'stock' shall include any certificate entitling the holder to voting power in the corporation.

"(b) OTHER PROVISIONS.—For purposes of sections 951(b), 952(a)(1)(C), and 954, section 318(a) (relating to constructive ownership of stock) shall apply to the extent that the effect is to subject a United States person to the requirement of section 951(a), to treat 5 or fewer United States persons as owning more than 50 percent of all classes of stock entitled to vote of a controlled foreign corporation, or to make a foreign corporation a controlled foreign corporation under secition 954, except—

"(1) In applying paragraph (1)(A) of section 318(a), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual.

"(2) In applying the first sentence of subparagraphs (A) and (B), and in applying clause (i) of subparagraph (C), of section 318(a)(2)—

"(A) if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote, and

"(B) if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total value of shares of all classes of stock of a corporation, it shall be considered as owning the total value of all of the outstanding stock of such corporation. The application of this subparagraph shall not have the effect of increasing voting power of a partner, beneficiary, or shareholder, for purposes of subparagraph (A).

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"(3) Stock owned by a partnership, estate, trust, or corporation, by reason of the application of the second sentence of subparagraphs (A) and (B), and the application of clause (ii) of subparagraph (C), of section 318(a)(2), shall not be considered as owned by such partnership, estate, trust, or corporation, for the purposes of applying the first sentence of subparagraphs (A) and (B), and in applying clause (i) of subparagraph (C), of section 318(a)(2).

"(4) In applying clause (i) of subparagraph (C) of section 318(a)(2), the 50-percent limitation contained in subparagraph (C) shall not apply.

"SEC. 956. EXCLUSION FROM GROSS INCOME OF PREVIOUSLY TAXED EARNINGS AND PROFITS.

"(a) EXCLUSION FROM GROSS INCOME OF UNITED STATES PERSONS.—For purposes of this chapter, the earnings and profits for a taxable year of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States person under section 951(a) shall not, when—

"(1) such amounts are distributed to, or

"(2) such amounts would, but for this subsection, be included under section 951(a)(1)(B) in the gross income of,

such person (or any other United States person who acquires from any person any portion of the interest of such United States person in such foreign corporation, but only to the extent of such portion, and subject to such proof of the identity of such interest as the Secretary or his delegate may by regulations prescribe) directly, or indirectly through a chain of ownership described under section 955(a), be again included in the gross income of such United States person (or of such other United States person).

"(b) EXCLUSION FROM GROSS INCOME OF CERTAIN FOREIGN SUBSIDIARIES.—For purposes of section 951(a), the earnings and profits for a taxable year of a controlled foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States person under section 951(a), shall not, when distributed through a chain of ownership described under section 955(a), be also included in the gross income of another controlled foreign corporation in such chain for purposes of the application of section 951(a) to such other controlled foreign corporation with respect to such United States person (or to any other United States person who acquires from any person any portion of the interest of such United States person in the controlled foreign corporation, but only to the extent of such portion, and subject to such proof of identity of such interest as the Secretary or his delegate may prescribe by regulations).

"(c) ALLOCATION OF DISTRIBUTIONS.—For purposes of subsections (a) and (b), section 316(a) shall be applied by applying paragraph (2) thereof, and then paragraph (1) thereof—

"(1) first to earnings and profits attributable to amounts included in gross income under section 951(a)(1)(B) (or which would have been included except for section 956(a)(2)),

"(2) then to earnings and profits attributable to amounts included in gross income under section 951(a)(1)(A) (but reduced by amounts not included under section 951(a)(1)(B) because of the exclusion in section 956(a)(2)), and

"(3) then to other earnings and profits.

"(d) DISTRIBUTIONS EXCLUDED FROM GROSS INCOME NOT TO BE TREATED AS DIVIDENDS.—Except as provided in section 957(a)(3), any distribution excluded from gross income under subsection (a) shall be treated, for purposes of this chapter, as a distribution which is not a dividend.

"SEC. 957. SPECIAL RULES FOR FOREIGN TAX CREDIT.

"(a) TAXES PAID BY A FOREIGN CORPORATION.—

"(1) GENERAL RULE.—For purposes of subpart A of this part, if there is included, under section 951(a), in the gross income of a domestic corporation any amount attributable to earnings and profits—

"(A) of a foreign corporation at least 10 percent of the voting stock of which is directly owned by such domestic corporation, or

"(B) of a foreign corporation at least 50 percent of the voting stock of which is directly owned by a foreign corporation at least 10 percent of the voting stock of which is in turn directly owned by such domestic corporation,

then, under regulations prescribed by the Secretary or his delegate, such domestic corporation shall be deemed to have paid the same proportion of

the total income, war profits, and excess profits taxes paid (or deemed paid, if, paragraph (4) applies) to a foreign country or possession of the United States for the taxable year which the amount of earnings and profits of such foreign corporation so included in gross income of the domestic corporation bears to the entire amount of the total earnings and profits of such foreign corporation for such taxable year.

"(2) TAXES PREVIOUSLY DEEMED PAID BY DOMESTIC CORPORATION.—If a domestic corporation receives a distribution from a foreign corporation, any portion of which is excluded from gross income under section 956, the income, war profits, and excess profits taxes paid or deemed paid by such foreign corporation to any foreign country or to any possession of the United States in connection with the earnings and profits of such foreign corporations from which such distribution is made shall not be taken into account for purposes of section 902, to the extent such taxes were deemed paid by such domestic corporation under paragraph (1) for any prior taxable year.

"(3) TAXES PAID BY FOREIGN CORPORATION AND NOT PREVIOUSLY DEEMED PAID BY DOMESTIC CORPORATION.—Any portion of a distribution from a foreign corporation received by a domestic corporation which is excluded from gross income under section 956(a) shall be treated by the domestic corporation as a dividend, solely for purposes of taking into account under section 902 any income, war profits, or excess profits taxes paid to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporations from which such distribution is made, which were not deemed paid by the domestic corporation under paragraph (1) for any prior taxable year.

"(4) TAXES PAID BY A FOREIGN SUBSIDIARY.—If subparagraph (A) of paragraph (1) applies with respect to an amount included in gross income under section 951(a) for a taxable year, then such amount shall be considered a dividend for purpose of the application of section 902(b).

"(5) INCLUSION IN GROSS INCOME.—

"For inclusion in gross income of amount equal to taxes deemed paid under paragraph (1), see section 78.

"(b) SPECIAL RULES FOR FOREIGN TAX CREDIT IN YEAR OF RECEIPT OF PREVIOUSLY TAXED EARNINGS AND PROFITS.—

"(1) INCREASE IN SECTION 904 LIMITATION.—In the case of any taxpayer who—

"(A) either (i) chose to have the benefits of subpart A of this part for a taxable year in which he was required under section 951(a) to include in his gross income an amount in respect of a controlled foreign corporation, or (ii) did not pay or accrue for such taxable year any income, war profits, or excess profits taxes to any foreign country or to any possession of the United States, and

"(B) chooses to have the benefits of subpart A of this part for the taxable year in which he receives a distribution or amount which is excluded from gross income under section 956(a) and which is attributable to earnings and profits of the controlled foreign corporation which was included in his gross income for the taxable year referred to in subparagraph (A), and

"(C) for the taxable year in which such distribution or amount is received, pays, or is deemed to have paid, or accrues income, war profits, or excess profits taxes to a foreign country or to any possession of the United States with respect to such distribution or amount,

the applicable limitation under section 904 for the taxable year in which such distribution or amount is received shall be increased as provided in paragraph (2), but such increase shall not exceed the amount of such taxes paid, or deemed paid, or accrued with respect to such distribution or amount.

"(2) AMOUNT OF INCREASE.—The amount of increase of the applicable limitation under section 904(a) for the taxable year in which the distribution or amount referred to in paragraph (1)(B) is received shall be an amount equal to—

"(A) the amount by which the applicable limitation under section 904(a) for the taxable year referred to in paragraph (1)(A) was increased by reason of the inclusion in gross income under section 951(a) of the amount in respect of the controlled foreign corporation, reduced by

"(B) the amount of any income, war profits, and excess profits taxes paid, or deemed paid, or accrued to any foreign country or possession of the United States which were allowable as a credit under section 901 for the taxable year referred to in paragraph (1)(A) and which

would not have been allowable but for the inclusion in gross income of the amount described in subparagraph (A).

"(3) CASES IN WHICH TAXES NOT TO BE ALLOWED AS DEDUCTION.—In the case of any taxpayer who—

"(A) chose to have the benefits of subpart A of this part for a taxable year in which he was required under section 951(a) to include in his gross income an amount in respect to a controlled foreign corporation, and

"(B) does not choose to have the benefits of subpart A of this part for the taxable year in which he receives a distribution or amount which is excluded from gross income under section 956(a) and which is attributable to earnings and profits of the controlled foreign corporation which was included in his gross income for the taxable year referred to in subparagraph (A),

no deduction shall be allowed under section 164 for the taxable year in which such distribution or amount is received for any income, war profits, or excess profits taxes paid or accrued to any foreign country or to any possession of the United States on or with respect to such distribution or amount.

"(4) INSUFFICIENT TAXABLE INCOME.—If an increase in the limitation under this subsection exceeds the tax imposed by this chapter for such year, the amount of such excess shall be deemed an overpayment of tax for such year.

"SEC. 958. ADJUSTMENTS TO BASIS OF STOCK IN CONTROLLED FOREIGN CORPORATION AND OF OTHER PROPERTY.

"(a) INCREASE IN BASIS.—Under regulations prescribed by the Secretary or his delegate, the basis of a United States person's stock in a controlled foreign corporation, and the basis of property of a United States person by reason of which he is considered under section 955(a)(2) as owning stock of a controlled foreign corporation, shall be increased by the amount required to be included in his gross income under section 951(a) with respect to such stock or with respect to such property, as the case may be, but only to the extent to which such amount was included in the gross income of such person.

"(b) REDUCTION IN BASIS.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary or his delegate, the adjusted basis of stock or other property with respect to which a United States person receives an amount which is excluded from gross income under section 956(a) shall be reduced by the amount so excluded.

"(2) AMOUNT IN EXCESS OF BASIS.—To the extent that an amount excluded from gross income under section 956(a) exceeds the adjusted basis of the stock or other property with respect to which it is received, the amount shall be treated as gain from the sale or exchange of property."

(b) TECHNICAL AND CLERICAL AMENDMENTS.—

(1) Section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) is amended by adding at the end thereof the following new sentence: "The amount included in the gross income of any United States shareholder for any taxable year under the preceding sentence shall be reduced by such shareholder's proportionate share of the undistributed personal holding company income which is included in his gross income under section 951(a)(1)(A) (relating to amounts included in gross income of United States persons) for such taxable year as his pro rata share of the subpart F income of the company."

(2) Section 901 (relating to foreign tax credit) is amended by striking out "section 902" and inserting in lieu thereof "sections 902 and 957".

(3) Section 902(e) is amended to read as follows:

"(e) CROSS REFERENCES.—

"(1) For application of subsections (a) and (b) with respect to taxes deemed paid in a prior taxable year a United States person with respect to a controlled foreign corporation, see section 957.

"(2) For reduction of credit with respect to dividends paid out of accumulated profits for years for which certain information is not furnished, see section 6038."

(4) Section 904(f) is amended to read as follows:

"(f) CROSS REFERENCES.—

"(1) For increase of applicable limitation under subsection (a) for taxes paid with respect to amounts received which were included in the gross income of the taxpayer for a prior taxable year as a United States person with respect to a controlled foreign corporation, see section 957(b).

"(2) For special rule relating to the application of the credit provided by section 901 in the case of affiliated groups which include Western Hemisphere trade corporations for years in which the limitation provided by subsection (a)(2) applies, see section 1503(d)."

(5) The table of subparts for part III of subchapter N of chapter 1 is amended by adding at the end thereof the following:

"Subpart F. Controlled foreign corporations."

(6) Section 1016(a) (relating to adjustments to basis) is amended—

(A) by striking out the period at the end of paragraph (18) and inserting in lieu thereof a semicolon; and

(B) by adding after paragraph (18) the following new paragraph:

"(19) to the extent provided in section 958 in the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States persons within which or with which such taxable years of such foreign corporations end.

SEC. 14. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY.

(a) IN GENERAL.—

(1) Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding at the end thereof the following new section:

"SEC. 1245. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY.

"(a) GENERAL RULE.—

"(1) ORDINARY RULE.—

"(1) ORDINARY INCOME.—Except as otherwise provided in this section, if section 1245 property is disposed of after the date of the enactment of the Revenue Act of 1962, the amount by which the lower of—

"(A) the recomputed basis of the property, or

"(B)(i) in the case of a sale, exchange, or involuntary conversion, the amount realized, or

"(ii) in the case of any other disposition, the fair market value of such property,

exceeds the adjusted basis of such property shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provision of this subtitle.

"(2) RECOMPUTED BASIS.—For purposes of this section, the term 'recomputed basis' means, with respect to any property, its adjusted basis recomputed by adding thereto all adjustments, for taxable years beginning after December 31, 1961, reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation, or for amortization under section 168. For purposes of the preceding sentence, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation, or for amortization under section 168, for any taxable year was less than the amount allowable, the amount added for such taxable year shall be the amount allowed.

"(3) SECTION 1245 PROPERTY.—For purposes of this section, the term 'section 1245 property' means any property (other than livestock) which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either—

"(A) personal property, or

"(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)—

"(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

"(ii) constituted research or storage facilities used in connection with any of the activities referred to in clause (i).

"(b) EXCEPTIONS AND LIMITATIONS.—

"(1) GIFTS.—Subsection (a) shall not apply to a disposition by gift.

"(2) TRANSFERS AT DEATH.—Except as provided in section 691 (relating to income in respect of a decedent), subsection (a) shall not apply to a transfer at death.

"(3) CERTAIN TAX-FREE TRANSACTIONS.—If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). This paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

"(4) LIKE KIND EXCHANGE; INVOLUNTARY CONVERSIONS, ETC.—If property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1031 or 1033, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the sum of—

"(A) the amount of gain recognized on such disposition (determined without regard to this section), plus

"(B) the fair market value of property acquired which is not section 1245 property and which is not taken into account under subparagraph (A).

"(5) SECTION 1071 AND 1081 TRANSACTIONS.—Under regulations prescribed by the Secretary or his delegate, rules consistent with paragraphs (3) and (4) of this subsection shall apply in the case of transactions described in section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or section 1081 (relating to exchanges in obedience to SEC orders).

"(6) PROPERTY DISTRIBUTED BY A PARTNERSHIP TO A PARTNER.—

"(A) IN GENERAL.—For purposes of this section, the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

"(B) ADJUSTMENTS ADDED BACK.—In the case of any property described in subparagraph (A), for purposes of computing the recomputed basis of such property the amount of the adjustments added back for periods before the distribution by the partnership shall be—

"(i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time, reduced by

"(ii) the amount of such gain to which section 751(b) applied.

"(c) ADJUSTMENTS TO BASIS.—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain recognized under subsection (a).

"(d) APPLICATION OF SECTION.—This section shall apply notwithstanding any other provision of this subtitle."

(2) The table of sections for such part IV is amended by adding at the end thereof the following:

"Sec. 1245. Gain from dispositions of certain depreciable property."

(b) CHANGE IN METHOD OF DEPRECIATION.—Subsection (e) of section 167 (relating to depreciation) is amended to read as follows:

"(e) CHANGE IN METHOD.—

"(1) CHANGE FROM DECLINING BALANCE METHOD.—In the absence of an agreement under subsection (d) containing a provision to the contrary, a taxpayer may at any time elect in accordance with regulations prescribed by the Secretary or his delegate to change from the method of depreciation described in subsection (b)(2) to the method described in subsection (b)(1).

"(2) CHANGE WITH RESPECT TO SECTION 1245 PROPERTY.—A taxpayer may, within such period after the date of the enactment of the Revenue Act of 1962 and in such manner as the Secretary or his delegate shall by regulations prescribe, elect to change his method of depreciation in respect of section 1245 property (as defined in section 1245(a)(3)) from any declining balance or sum of the years-digits method to the straight line method. An election may be made under this paragraph notwithstanding any provision to the contrary in an agreement under subsection (d)."

(c) SALVAGE VALUE OF PERSONAL PROPERTY.—

(1) AMOUNT TAKEN INTO ACCOUNT.—Section 167 (relating to depreciation) is amended by redesigning subsections (f), (g), and (h) as (g), (h), and

(i), respectively, and by inserting after subsection (e) the following new subsection:

"(f) SALVAGE VALUE.—

"(1) GENERAL RULE.—Under regulations prescribed by the Secretary or his delegate, a taxpayer may, for purposes of computing the allowance under subsection (a) with respect to personal property, reduce the amount taken into account as salvage value by an amount which does not exceed 10 percent of the basis of such property (as determined under subsection (g) as of the time as of which such salvage value is required to be determined).

"(2) PERSONAL PROPERTY DEFINED.—For purposes of this subsection, the term 'personal property' means depreciable personal property (other than livestock) with a useful life of 3 years or more acquired after the date of the enactment of the Revenue Act of 1962."

(2) CONFORMING AMENDMENTS.—

(A) Sections 179(d)(5) and 642(e) are each amended by striking out "167(g)" and inserting in lieu thereof "167(h)".

(B) Section 179(d)(8) is amended by striking out "167(f)" and inserting in lieu thereof "167(g)".

(d) SPECIAL RULE FOR CHARITABLE CONTRIBUTIONS OF SECTION 1245 PROPERTY.—Section 170 (relating to charitable, etc., contributions and gifts) is amended by redesignating subsections (e) and (f) as (f) and (g), respectively, and by inserting after subsection (d) the following new subsection:

"(e) SPECIAL RULE FOR CHARITABLE CONTRIBUTIONS OF SECTION 1245 PROPERTY.—The amount of any charitable contribution taken into account under this section shall be reduced by the amount which would have been treated as gain to which section 1245(a) applies if the property contributed had been sold at its fair market value (determined at the time of such contribution)."

(e) TECHNICAL AMENDMENTS.—

(1) SPECIAL RULE FOR PARTNERSHIPS.—Section 751(c) (relating to definition of "unrealized receivables" for purposes of subchapter K) is amended by adding after paragraph (2) the following:

"For purposes of this section and sections 731, 736, and 741, such term also includes section 1245 property (as defined in section 1245(a)(3)), but only to the extent of the amount which would be treated as gain to which section 1245(a) would apply if (at the time of the transaction described in this section or section 731, 736, or 741, as the case may be) such property had been sold by the partnership at its fair market value."

(2) CORPORATE DISTRIBUTION OF PROPERTY.—Subsections (b) and (d) of section 301 (relating to amount distributed) are each amended by striking out "subsection (b) or (c) of section 311" and inserting in lieu thereof "subsection (b) or (c) of section 311 or under section 1245(a)".

(3) EFFECT ON EARNINGS AND PROFITS.—Section 312(c)(3) (relating to adjustments of earnings and profits) is amended by striking out "subsection (b) or (c) of section 311" and inserting in lieu thereof "subsection (b) or (c) of section 311 or under section 1245(a)".

(4) COLLAPSIBLE CORPORATIONS.—Section 341(e) (relating to collapsible corporations) is amended by inserting after paragraph (11) the following new paragraph:

"(12) NONAPPLICATION OF SECTION 1245(a).—For purposes of this subsection, the determination of whether gain from the sale or exchange of property would under any provision of this chapter be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) shall be made without regard to the application of section 1245(a)."

(5) INSTALLMENT OBLIGATIONS IN CERTAIN LIQUIDATIONS.—

(A) Section 453(d)(4)(A) (relating to distribution of installment obligations in section 332 liquidations) is amended by adding at the end thereof the following new sentence: "If the basis of the property of the liquidating corporation in the hands of the distributee is determined under section 334 (b)(2) then the preceding sentence shall not apply to the extent that under paragraph (1) gain to the distributing corporation would be considered as gain to which section 1245(a) applies."

(B) Section 453(d)(4)(B) (relating to distribution of installment obligations in liquidations to which section 337 applies) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply to the extent that under paragraph (1) gain

to the distributing corporation would be considered as gain to which section 1245(a) applies."

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1961, and ending after the date of the enactment of this Act.

SEC. 15. FOREIGN INVESTMENT COMPANIES.

(a) TREATMENT OF SALE OF STOCK OF FOREIGN INVESTMENT COMPANIES.—

(1) IN GENERAL.—Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding after section 1245 (as added by section 14 of this Act) the following new sections:

"SEC. 1246. GAIN ON FOREIGN INVESTMENT COMPANY STOCK.

"(a) TREATMENT OF GAIN AS ORDINARY INCOME.—

"(1) GENERAL RULE.—In the case of a sale or exchange after December 31, 1962, of stock in a foreign corporation which was a foreign investment company (as defined in subsection (b)) at any time during the period during which the taxpayer held such stock, any gain shall be treated as gain from the sale or exchange of property which is not a capital asset, to the extent of the taxpayer's ratable share of the earnings and profits of such corporation accumulated for taxable years beginning after December 31, 1962.

"(2) RATABLE SHARE.—For purposes of this section, the taxpayer's ratable share shall be determined under regulations prescribed by the Secretary or his delegate, but shall include only his ratable share of the accumulated earnings and profits of such corporation—

"(A) for the period during which the taxpayer held such stock, but

"(B) excluding such earnings and profits which were taxed to such taxpayer under section 951 or under section 551.

"(3) TAXPAYER TO ESTABLISH EARNINGS AND PROFITS.—Unless the taxpayer establishes the amount of the accumulated earnings and profits of the foreign investment company and the ratable share thereof for the period during which the taxpayer held such stock, all the gain from the sale or exchange of stock in such company shall be considered as gain from the sale or exchange of property which is not a capital asset.

"(4) HOLDING PERIOD OF STOCK MUST BE MORE THAN 6 MONTHS.—This section shall not apply with respect to the sale or exchange of stock where the holding period of such stock as of the date of such sale or exchange is 6 months or less.

"(b) DEFINITION OF FOREIGN INVESTMENT COMPANY.—For purposes of this section, the term 'foreign investment company' means any foreign corporation—

"(1) registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2), either as a management company or as a unit investment trust, or

"(2) engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (within the meaning of section 3(a)(1) of such Act) at a time when more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or of the total value of shares of all classes of stock, was held, directly or indirectly (within the meaning of section 955(a)), by United States persons (as defined in section 7701(a)(30)).

"(c) STOCK HAVING TRANSFERRED OR SUBSTITUTED BASIS.—To the extent provided in regulations prescribed by the Secretary or his delegate, stock in a foreign corporation, the basis of which (in the hands of the taxpayer selling or exchanging such stock) is determined by reference to the basis (in the hands of such taxpayer or any other person) of stock in a foreign investment company, shall be treated as stock of a foreign investment company and held by the taxpayer throughout the holding period for such stock (determined under section 1223).

"(d) RULES RELATING TO ENTITIES HOLDING FOREIGN INVESTMENT COMPANY STOCK.—To the extent provided in regulations prescribed by the Secretary or his delegate—

"(1) trust certificates of a trust to which section 677 (relating to income for benefit of grantor) applies, and

"(2) stock of a domestic corporation,

shall be treated as stock of a foreign investment company and held by the taxpayer throughout the holding period for such certificates or stock (determined under section 1223) in the same proportion that the investment in stock

in a foreign investment company by the trust or domestic corporation bears to the total assets of such trust or corporation.

"(e) Rules Relating to Stock Acquired From a Decedent.—

"(1) Basis.—In the case of stock of a foreign investment company acquired by bequest, devise, or inheritance (or by the decedent's estate) from a decedent dying after December 31, 1962, the basis determined under section 1014 shall be reduced (but not below the adjusted basis of such stock in the hands of the decedent immediately before his death) by the amount of the decedent's ratable share of the accumulated earnings and profits of such company. Any stock so acquired shall be treated as stock described in subsection (c).

"(2) Deduction for estate tax.—If stock to which subsection (a) applies is acquired from a decedent, the taxpayer shall, under regulations prescribed by the Secretary or his delegate, be allowed (for the taxable year of the sale or exchange) a deduction from gross income equal to that portion of the decedent's estate tax deemed paid which is attributable to the excess of (A) the value at which such stock was taken into account for purposes of determining the value of the decedent's gross estate, over (B) the value at which it would have been so taken into account if such value had been reduced by the amount described in paragraph (1).

"(f) Information With Respect to Certain Foreign Investment.—Every United States person who, on the last day of the taxable year of a foreign investment company beginning after December 31, 1962, owns 5 percent or more in value of the stock of such company shall furnish with respect to such company such information as the Secretary or his delegate shall by regulations prescribe.

"(g) Cross Reference.—

"For special rules relating to the earnings and profits of foreign investment companies, see section 312(1).

"SEC. 1247. ELECTION BY FOREIGN INVESTMENT COMPANIES TO DISTRIBUTE INCOME CURRENTLY.

"(a) Election by Foreign Investment Company.—

"(1) In general.—If a foreign investment company which is described in section 1246(b)(1) elects (in the manner provided in regulations prescribed by the Secretary or his delegate) on or before December 31, 1962, with respect to each taxable year beginning after December 31, 1962, to—

"(A) distribute to its shareholders 90 percent or more of what its taxable income would be if it were a domestic corporation;

"(B) designate in a written notice mailed to its shareholders at any time before the expiration of 30 days after the close of its taxable year the pro rata amount of the excess (determined as if such corporation were a domestic corporation) of the net long-term capital gains over the net short-term capital losses; and the portion thereof which is being distributed; and

"(C) provide such information as the Secretary or his delegate deems necessary to carry out the purposes of this section,

then section 1246 shall not apply with respect to the qualified shareholders of such company during any taxable year to which such election applies.

"(2) Special rules.—

"(A) Computation of taxable income.—For purposes of paragraph (1)(A), the taxable income of the company shall be computed without regard to—

"(i) the excess of capital gains over losses referred to in paragraph (1)(B),

"(ii) section 172 (relating to net operating losses), and

"(iii) any deduction provided by part VIII of subchapter B (other than the deduction provided by section 248, relating to organizational expenditures).

"(B) Distributions after the close of the taxable year.—For purposes of paragraph (1)(A), a distribution made after the close of the taxable year and on or before the 15th day of the third month of the next taxable year shall be treated as distributed during the taxable year to the extent elected by the company (in accordance with regulations prescribed by the Secretary or his delegate) on or before the 15th day of such third month.

"(C) Carryover of capital losses from nonelection years denied.—In computing the excess of capital gains over losses referred to in paragraph (1)(B), section 1212 shall not apply to losses incurred in or

with respect to taxable years before the first taxable year to which the election applies.

"(b) YEARS TO WHICH ELECTION APPLIES.—The election of any foreign investment company under this section shall terminate as of the close of the taxable year preceding its first taxable year in which any of the following occurs:

"(1) the company fails to comply with the provisions of subparagraph (A), (B), or (C) of subsection (a)(1), unless it is shown that such failure is due to reasonable cause and not due to willful neglect,

"(2) the company is a foreign personal holding company, or

"(3) the company is not a foreign investment company which is described in section 1246(b)(1).

"(c) QUALIFIED SHAREHOLDERS.—For purposes of this section—

"(1) IN GENERAL.—The term 'qualified shareholder' means any shareholder who is a United States person, other than a shareholder described in paragraph (2).

"(2) CERTAIN UNITED STATES PERSONS EXCLUDED FROM DEFINITION.—A United States person shall not be treated as a qualified shareholder for the taxable year if for such taxable year (or for any prior taxable year) he did not include, in computing his long-term capital gains in his return for such taxable year, the amount designated by such company pursuant to subsection (a)(1)(B) as his share of the undistributed capital gains of such company for its taxable year ending within or with such taxable year of the taxpayer. The preceding sentence shall not apply with respect to any failure by the taxpayer to treat an amount as provided therein if the taxpayer shows that such failure was due to reasonable cause and not due to willful neglect.

"(d) ADJUSTMENTS.—Under regulations prescribed by the Secretary or his delegate, proper adjustment shall be made—

"(1) in the earnings and profits of the electing foreign investment company, and

"(2) the adjusted basis of stock of such company held by qualified shareholders,

to reflect the inclusion in gross income by such shareholders of undistributed capital gains.

"(e) LOSS ON SALE OR EXCHANGE OF CERTAIN STOCK HELD LESS THAN 6 MONTHS.—If—

"(1) under this section, any qualified shareholder treats any amount designated under subsection (a)(1)(B) with respect to a share of stock as long-term capital gain, and

"(2) such share is held by the taxpayer for less than 6 months,

then any loss on the sale or exchange of such share shall, to the extent of the amount described in paragraph (1), be treated as loss from the sale or exchange of a capital asset held for more than 6 months."

(2) The table of sections for such part IV is amended by adding at the end theerof the following:

"Sec. 1246. Gain on foreign investment company.
"Sec. 1247. Election by foreign investment companies to distribute income currently."

(b) CONFORMING AMENDMENTS.—

(1) EARNINGS AND PROFITS OF FOREIGN INVESTMENT COMPANIES.—Section 312 (relating to effect on earnings and profits) is amended by adding after subsection (k) the following new subsection:

"(l) EARNINGS AND PROFITS OF FOREIGN INVESTMENT COMPANIES.—

"(1) ALLOCATION WITHIN AFFILIATED GROUP.—In the case of a sale or exchange of stock in a foreign investment company (as defined in section 1246(b)) by a United States person (as defined in section 7701(a)(30)), if such company is a member of an affiliated group, then the accumulated earnings and profits of all members of such affiliated group shall be allocated, under regulations prescribed by the Secretary or his delegate, in such manner as is proper to carry out the purposes of section 1246.

"(2) AFFILIATED GROUP DEFINED.—For purposes of paragraphs (1) and (2) of this subsection, the term 'affiliated group' has the meaning assigned to such term by section 1504(a); except that (A) 'more than 50 percent' shall be submitted for '80 percent or more', and (B) all corporations shall be treated as includible corporations (without regard to the provisions of section 1504(b)).

"(3) PARTIAL LIQUIDATIONS AND REDEMPTIONS.—

"(A) IN GENERAL.—If a foreign investment company (as defined in section 1246) distributes amounts in partial liquidation or in a redemption to which section 302(a) or 303 applies, the part of such distribution which is properly chargeable to earnings and profits shall be an amount which is not in excess of the ratable share of the earnings and profits of the company accumulated after February 28, 1913, attributable to the stock so redeemed.

"(B) EFFECTIVE DATE.—Subparagraph (A) shall apply only with respect to distributions made after December 31, 1962."

(2) SALE OR EXCHANGE OF INTEREST IN PARTNERSHIP.—Section 751(d)(2) (relating to inventory items which have appreciated substantially in value) is amended by striking out "and" at the end of subparagraph (B), and by striking out subparagraph (C) and inserting in lieu thereof the following new subparagraphs:

"(C) any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under subsection (a) of section 1246 (relating to gain on foreign investment company stock), and

"(D) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in subparagraph (A), (B), or (C)."

(3) HOLDING PERIOD OF PROPERTY.—Section 1223 (relating to holding period of property) is amended by redesignating pargaraph (10) as paragraph (11) and inserting after paragraph (9) the following paragraph:

"(10) In determining the period for which the taxpayer has held trust certificates of a trust to which subsection (d) of section 1246 applies, or the period for which the taxpayer has held stock in a corporation to which subsection (d) of section 1246 applies, there shall be included the period for which the trust or corporation (as the case may be) held the stock of foreign investment companies."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1962.

SEC. 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS.

(a) TREATMENT OF GAIN FROM THE REDEMPTION, CANCELLATION, OR SALE OF STOCK IN CERTAIN FOREIGN CORPORATIONS.—Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding after section 1247 (as added by section 15 of this Act) the following new section:

"SEC. 1248. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS.

"(a) REDEMPTIONS AND LIQUIDATIONS.—If a foreign corporation redeems its stock in an exchange to which section 302(a) applies, or if a foreign corporation cancels its stock in a complete or partial liquidation in an exchange to which section 331 applies, then the gain of a United States person (as defined in section 7701(a)(30)) from the exchange of such stock shall be included in the gross income of such person as a dividend, to the extent of such person's proportionate share of the earnings and profits of the foreign corporation accumulated after February 28, 1913.

"(b) SALES AND OTHER EXCHANGES.—If a United States person (as defined in section 7701(a)(30)) sells or exchanges stock in a foreign corporation, then the gain recognized on the sale or exchange of such stock shall be considered as gain from the sale or exchange of property which is not a capital asset, to the extent of such person's proportionate share of the earnings and profits of the foreign corporation accumulated during the period the stock sold or exchanged was held by such person.

"(c) LIMITATIONS.—

"(1) CONTROLLED FOREIGN CORPORATIONS.—Subsections (a) and (b) shall apply only if the foreign corporation the stock of which is sold or exchanged (A) is a controlled foreign corporation (as defined in section 954) at the time of the sale or exchange, or (B) was such a controlled foreign corporation at any time during the 5-year period ending on the date of the sale or exchange.

"(2) 10-PERCENT OWNERSHIP.—Subsections (a) and (b) shall apply only to a United States person who can be considered, by applying the rules of con-

structive ownership of section 955(b), as being the owner, directly or indirectly, of 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation at the time of the sale or exchange, or at any time during the 5-year period ending on the date of the sale or exchange.

"(3) ELIMINATION FROM EARNINGS AND PROFITS OF AMOUNTS INCLUDED IN GROSS INCOME UNDER SECTION 951.—In determining the amount to be considered a dividend under subsection (a), or as gain from the sale or exchange of property which is not a capital asset under subsection (b), the United States person's proportionate share of earnings and profits of the foreign corporation shall be reduced by the amount previously included in the gross income of such person under section 951, with respect to the stock sold or exchanged, but only to the extent such amount did not result in an exclusion from gross income under section 956.

"(4) REDEMPTIONS TO PAY DEATH TAXES.—Subsections (a) and (b) shall not apply to distributions to which section 303 (relating to distributions in redemption of stock to pay death taxes) applies.

"(5) ADDITIONAL CONSIDERATION IN CERTAIN REORGANIZATIONS.—Subsection (b) shall not apply to gain recognized or exchanges to which section 356 (relating to receipt of additional consideration in certain reorganizations) applies.

"(6) TREATMENT OF AMOUNTS WHICH ARE ORDINARY INCOME, ETC., UNDER OTHER PROVISIONS.—Subsections (a) and (b) shall not apply with respect to any amount to the extent that such amount is, under any other provision of this title, treated as—

"(A) a dividend,

"(B) gain from the sale of an asset which is not a capital asset, or

"(C) gain from the sale of an asset held for not more than 6 months.

"(d) TAXPAYER TO ESTABLISH EARNINGS AND PROFITS.—Unless the taxpayer establishes the amount of the earnings and profits of the foreign corporation to be taken into account under subsections (a) and (b), all gain from the sale or exchange shall be considered a dividend under subsection (a), or as gain from the sale or exchange of property which is not a capital asset under subsection (b), whichever applies."

(b) CLERICAL AMENDMENT.—The table of sections for such part IV is amended by adding at the end thereof the following:

"Sec. 1248. Gain from certain sales or exchanges of stock in certain foreign corporations."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to sales or exchanges occurring after the date of the enactment of this Act.

SEC. 17. TAX TREATMENT OF COOPERATIVES AND PATRONS.

(a) IN GENERAL.—Chapter 1 (relating to normal taxes and surtaxes) is amended by adding at the end thereof the following new subchapter:

"Subchapter T—Cooperatives and Their Patrons

"Part I. Tax treatment of cooperatives.
"Part II. Tax treatment by patrons of patronage dividends.
"Part III. Definitions; special rules.

"PART I—TAX TREATMENT OF COOPERATIVES

"Sec. 1381. Organizations to which part applies.
"Sec. 1382. Taxable income of cooperatives.
"Sec. 1383. Computation of tax where cooperative redeems nonqualified written notices of allocation.

"SEC. 1381. ORGANIZATIONS TO WHICH PART APPLIES.

"(a) IN GENERAL.—This part shall apply to—

"(1) any organization exempt from tax under section 521 (relating to exemption of farmers' cooperatives from tax), and

"(2) any corporation operating on a cooperative basis other than an organization—

"(A) which is exempt from tax under this chapter,

"(B) which is subject to the provisions of—

"(i) part II of subchapter H (relating to mutual savings banks, etc.), or

"(ii) subchapter L (relating to insurance companies), or

"(C) which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas.

"(b) TAX ON CERTAIN FARMERS' COOPERATIVES.—An organization described in subsection (a)(1) shall be subject to the taxes imposed by section 11 or 1201.

"SEC. 1382. TAXABLE INCOME OF COOPERATIVES.

"(a) GROSS INCOME.—Except as provided in subsection (b), the gross income of any organization to which this part applies shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of the net earnings of such organization.

"(b) PATRONAGE DIVIDENDS.—In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year—

"(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d))) with respect to patronage occurring during such taxable year; or

"(2) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred.

For purposes of this title, any amount not taken into account under the preceding sentence shall be treated in the same manner as an item of gross income and as a deduction therefrom.

"(c) DEDUCTION FOR NONPATRONAGE DISTRIBUTIONS, ETC.—In determining the taxable income of an organization described in section 1381(a)(1), there shall be allowed as a deduction (in addition to other deductions allowable under this chapter)—

"(1) amounts paid during the taxable year as dividends on its capital stock; and

"(2) amounts paid during the payment period for the taxable year—

"(A) in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation) on a patronage basis to patrons with respect to its earnings during such taxable year which are derived from business done for the United States or any of its agencies or from sources other than patronage, or

"(B) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid, during the payment period for the taxable year during which the earnings were derived, on a patronage basis to a patron with respect to earnings derived from business or sources described in subparagraph (A).

"(d) PAYMENT PERIOD FOR EACH TAXABLE YEAR.—For purposes of subsections (b) and (c)(2), the payment period for any taxable year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year.

"(e) PRODUCTS MARKETED UNDER POOLING ARRANGEMENTS.—For purposes of subsection (b), in the case of a pooling arrangement for the marketing of products, the patronage shall (to the extent provided in regulations prescribed by the Secretary or his delegate) be treated as patronage occurring during the taxable year in which the pool closes.

"(f) TREATMENT OF EARNINGS RECEIVED AFTER PATRONAGE OCCURRED.—If any portion of the earnings from business done with or for patrons is includible in the organization's gross income for a taxable year after the taxable year during which the patronage occurred, then for purposes of applying subsection (b) to such portion the patronage shall, to the extent provided in regulations prescribed by the Secretary or his delegate, be considered to have occurred during the taxable year of the organization during which such earnings are includible in gross income.

"SEC. 1383. COMPUTATION OF TAX WHERE COOPERATIVE REDEEMS NONQUALIFIED WRITTEN NOTICES OF ALLOCATION.

"(a) GENERAL RULE.—If, under section 1382(b)(2) or (c)(2)(B), a deduction is allowable to an organization for the taxable year for amounts paid in redemption of nonqualified written notices of allocation, then the tax imposed by this

chapter on such organization for the taxable year shall be the lesser of the following:

"(1) the tax for the taxable year computed with such deduction; or

"(2) an amount equal to—

"(A) the tax for the taxable year computed without such deduction, minus

"(B) the decrease in tax under this chapter for any prior taxable year (or years) which would result solely from treating such nonqualified written notices of allocation as qualified written notices of allocation.

"(b) SPECIAL RULES.—

"(1) If the decrease in tax ascertained under subsection (a)(2)(B) exceeds the tax for the taxable year (computed without the deduction described in subsection (a)) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.

"(2) For purposes of determining the decrease in tax under subsection (a)(2)(B), the stated dollar amount of any nonqualified written notice of allocation which is to be treated under such subsection as a qualified written notice of allocation shall be the amount paid in redemption of such written notice of allocation which is allowable as a deduction under section 1382(b)(2) or (c)(2)(B) for the taxable year.

"(3) If the tax imposed by this chapter for the taxable year is the amount determined under subsection (a)(2), then the deduction described in subsection (a) shall not be taken into account for any purpose of this subtitle other than for purposes of this section.

"PART II—TAX TREATMENT BY PATRONS OF PATRONAGE DIVIDENDS

"Sec. 1385. Amounts includible in patron's gross income.

"SEC. 1385. AMOUNTS INCLUDIBLE IN PATRON'S GROSS INCOME.

"(a) GENERAL RULE.—Except as otherwise provided in subsection (b), each person shall include in gross income—

"(1) the amount of any patronage dividend which is paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation), and which is received by him during the taxable year from an organization described in section 1381(a), and

"(2) any amount, described in section 1382(c)(2)(A) (relating to certain nonpatronage distributions by tax-exempt farmers' cooperatives), which is paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation), and which is received by him during the taxable year from an organization described in section 1381(a)(1).

"(b) EXCLUSION FROM GROSS INCOME.—Under regulations prescribed by the Secretary or his delegate, the amount of any patronage dividend, and any amount received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was paid as a patronage dividend, shall not be included in gross income to the extent that such amount—

"(1) is properly taken into account as an adjustment to basis of property, or

"(2) is atributable to personal, living, or family items.

"(c) TREATMENT OF CERTAIN NONQUALIFIED WRITTEN NOTICES OF ALLOCATION.—

"(1) APPLICATION OF SUBSECTION.—This subsection shall apply to any nonqualified written notice of allocation which—

"(A) was paid as a patronage dividend, or

"(B) was paid by an organization described in section 1381(a)(1) on a patronage basis with respect to earnings derived from business or sources described in section 1382(c)(2)(A).

"(2) BASIS; AMOUNT OF GAIN.—In the case of any nonqualified written notice of allocation to which this subsection applies, for purposes of this chapter—

"(A) the basis of such written notice of allocation in the hands of the patron to whom such written notice of allocation was paid shall be zero,

"(B) the basis of such written notice of allocation which was acquired from a decedent shall be its basis in the hands of the decedent, and

"(C) gain on the redemption, sale, or other disposition of such written notice of allocation by any person shall, to the extent that the stated dollar amount of such written notice of allocation exceeds its basis, be considered as gain from the sale or exchange of property which is not a capital asset.

"PART III—DEFINITIONS; SPECIAL RULES

"Sec. 1388. Definitions; special rules.

"SEC. 1388. DEFINITIONS; SPECIAL RULES.

"(a) PATRONAGE DIVIDEND.—For purposes of this subchapter, the term 'patronage dividend' means an amount paid to a patron by an organization to which part I of this subchapter applies—

"(1) on the basis of quantity or value of business done with or for such patron,

"(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

"(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

"(b) WRITTEN NOTICE OF ALLOCATION.—For purposes of this subchapter, the term 'written notice of allocation' means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage dividend.

"(c) QUALIFIED WRITTEN NOTICE OF ALLOCATION.—

"(1) DEFINED.—For purposes of this subchapter, the term 'qualified written notice of allocation' means—

"(A) a written notice of allocation which may be redeemed in cash as its stated dollar amount at any time within a period beginning on the date such written notice of allocation is paid and ending not earlier than 90 days from such date, but only if the distributee receives written notice of the right of redemption at the time he receives such written notice of allocation; and

"(B) a written notice of allocation which the distributee has consented, in the manner provided in paragraph (2), to take into account at its stated dollar amount as provided in section 1385(a).

"(2) MANNER OF OBTAINING CONSENT.—A distributee shall consent to take a written notice of allocation into account as provided in paragraph (1)(B) only by—

"(A) making such consent in writing ,or

"(B) obtaining or retaining membership in the organization after—

"(i) such organization has adopted (after the date of the enactment of the Revenue Act of 1962) a bylaw providing that membership in the organization constitutes such consent, and

"(ii) he has received a written notification and copy of such bylaw.

"(3) PERIOD FOR WHICH CONSENT IS EFFECTIVE.—

"(A) GENERAL RULE.—Except as provided in subparagraph (B)—

"(i) a consent described in paragraph (2)(A) shall be a consent with respect to all patronage of the distributee with the organization occurring (determined with the application of section 1382(e)) during the taxable year of the organization during which such consent is made and all subsequent taxable years of the organization; and

"(ii) a consent described in paragraph (2)(B) shall be a consent with respect to all patronage of the distributee with the organization occurring (determined without the application of section 1382(e)) after he received the notification and copy described in paragraph (2)(B)(ii).

"(B) REVOCATION, ETC.—

"(i) Any consent described in paragraph (2)(A) may be revoked (in writing) by the distributee at any time. Any such revocation shall be effective with respect to patronage occurring on or after the first day of the first taxable year of the organization beginning after the revocation is filed with such organization: except that in the case of a pooling arrangement described in section 1382(e), a revocation made by a distributee shall not be effective as to any pool with respect to which the distributee has been a patron before such revocation.

"(ii) Any consent described in paragraph (2)(B) shall not be effective with respect to any patronage occurring (determined without the application of section 1382(e)) after the distributee ceases to be a member of the organization or after the bylaws of the organization cease to contain the provision described in paragraph (2)(B)(i).

"(d) NONQUALIFIED WRITTEN NOTICE OF ALLOCATION.—For purposes of this subchapter, the term 'nonqualified written notice of allocation' means a written notice of allocation which is not described in subsection (c).

"(e) DETERMINATION OF AMOUNT PAID OR RECEIVED.—For purposes of this subchapter, in determining amount paid or received—

"(1) property (other than a written notice of allocation) shall be taken into account at its fair market value, and

"(2) a qualified written notice of allocation shall be taken into account at its stated dollar amount."

(b) TECHNICAL AMENDMENTS.—

(1) Section 521(a) (relating to exemption of farmers' cooperatives from tax) is amended by striking out "section 522" each place it appears therein and inserting in lieu thereof "part I of subchapter T (sec. 1381 and following)".

(2) Section 522 (relating to tax on farmers' cooperatives) is hereby repealed.

(3) Section 6044 (relating to returns regarding patronage dividends) is amended to read as follows:

"SEC. 6044. RETURNS REGARDING PATRONAGE DIVIDENDS.

"Any organization to which part I of subchapter T of chapter 1 (relating to tax treatment of cooperatives) applies which pays amounts described in section 1382(b), or (in the case of an organization described in section 1381(a)(1)) amounts described in section 1382(c)(2), shall, when required by regulations of the Secretary or his delegate, make a return showing—

"(1) the name and address of each patron to whom it has made such payments during the calendar year; and

"(2) the amount of such payments to each patron."

(4) Section 6072(d) (relating to time for filing income tax returns of exempt cooperative associations) is amended to read as follows:

"(d) RETURNS OF COOPERATIVE ASSOCIATIONS.—In the case of an income tax return of—

"(1) an exempt cooperative association described in section 1381(a)(1), or

"(2) an organization described in section 1381(a)(2) which is under an obligation to pay patronage dividends (as defined in section 1388(a)) in an amount equal to at least 50 percent of its net earnings from business done with or for its patrons, or which paid patronage dividends in such an amount out of the net earnings from business done with or for patrons during the most recent taxable year for which it had such net earnings,

a return made on the basis of a calendar year shall be filed on or before the 15th day of September following the close of the calendar year, and a return made on the basis of a fiscal year shall be filed on or before the 15th day of the 9th month following the close of the fiscal year."

(5) The table of subchapters for chapter 1 is amended by adding at the end thereof the following:

"SUBCHAPTER T. Cooperatives and their patrons."

(6) The table of sections for part III of subchapter F of chapter 1 is amended by striking out the last line thereof.

(c) EFFECTIVE DATES.—

(1) FOR THE COOPERATIVES.—Except as provided in paragraph (3), the amendments made by subsections (a) and (b) shall apply to taxable years

of organizations described in section 1381(a) of the Internal Revenue Code of 1954 (as added by subsection (a)) beginning after December 31, 1962.

(2) For the patrons.—Except as provided in paragraph (3), section 1385 of the Internal Revenue Code of 1954 (as added by subsection (a)) shall apply with respect to any amount received from any organization described in section 1381 (a) of such Code, to the extent that such amount is paid by such organization in a taxable year of such organization beginning after December 31, 1962.

(3) Application of existing law.—In the case of any money, written notice of allocation, or other property paid by any organization described in section 1381(a)—

(A) before the first day of the first taxable year of such organization beginning after December 31, 1962, or

(B) on or after such first day with respect to patronage occurring before such first day,

the tax treatment of such money, written notice of allocation, or other property (including the tax treatment of gain or loss on the redemption, sale, or other disposition of such written notice of allocation) by any person shall be made under the Internal Revenue Code of 1954 without regard to subchapter T of chapter 1 of such Code.

SEC. 18. INCLUSION OF FOREIGN REAL PROPERTY IN GROSS ESTATE.

(a) Amendments To Include Foreign Real Property.—

(1) Section 2031(a) (relating to definition of gross estate) is amended by striking out ", except real property situated outside of the United States".

(2) The following provisions of chapter 11 (imposing an estate tax) are amended by striking out "(except real property situated outside of the United States)":

(A) section 2033 (relating to property in which the decedent had an interest),

(B) section 2034 (relating to dower or curtesy interests),

(C) section 2035(a) (relating to transactions in contemplation of death),

(D) section 2036(a) (relating to transfers with retained life estate),

(E) section 2037(a) (relating to transfers taking effect at death),

(F) section 2038(a) (relating to revocable transfers),

(G) section 2040 (relating to joint interests), and

(H) section 2041(a) (relating to powers of appointment).

(b) Effective Date.—

(1) Except as provided in paragraph (2), the amendments made by subsection (a) shall apply to the estates of decedents dying after the date of the enactment of this Act.

(2) In the case of a decedent dying after the date of the enactment of this Act and before July 1, 1964, the value of real property situated outside of the United States shall not be included in the gross estate (as defined in section 2031(a)) of the decedent—

(A) under section 2033, 2034, 2035(a), 2036(a), 2037(a), or 2038(a) to the extent the real property, or the decedent's interest in it, was acquired by the decedent before February 1, 1962;

(B) under section 2040 to the extent such property or interest was acquired by the decedent before February 1, 1962, or was held by the decedent and the survivor in a joint tenancy or tenancy by the entirety before February 1, 1962; or

(C) under section 2041(a) to the extent that before February 1, 1962, such property or interest was subject to a general power of appointment (as defined in section 2041) possessed by the decedent.

In the case of real property, or an interest therein, situated outside of the United States (including a general power of appointment in respect of such property or interest, and including property held by the decedent and the survivor in a joint tenancy or tenancy by the entirety) which was acquired by the decedent after January 31, 1962, by gift within the meaning of section 2511, or from a prior decedent by devise or inheritance, or by reason of death, form of ownership, or other conditions (including the exercise or nonexercise of a power of appointment) for purposes of this paragraph such property or interest therein shall be deemed to have been acquired

by the decedent before February 1, 1962, if before that date the donor or prior decedent had acquired the property or his interest therein or had possessed a power of appointment in respect of the property or interest.

SEC. 19. WITHHOLDING OF INCOME TAX AT SOURCE ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS.

(a) IN GENERAL.—

(1) AMENDMENT OF SUBTITLE C.—Subtitle C (relating to employment taxes and collection of income tax at source) is amended by redesignating chapter 25 as chapter 26 and by inserting after chapter 24 the following new chapter:

"CHAPTER 25—COLLECTION OF INCOME TAX AT SOURCE ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

"SUBCHAPTER A. Interest.
"SUBCHAPTER B. Dividends.
"SUBCHAPTER C. Patronage dividends.
"SUBCHAPTER D. General provisions.

"Subchapter A—Interest

"Sec. 3451. Income tax collected at source on interest.
"Sec. 3452. Interest defined.

"SEC. 3451. INCOME TAX COLLECTED AT SOURCE ON INTEREST.

"(a) REQUIREMENT OF WITHHOLDING.—Except as otherwise provided in this chapter, every person who pays interest shall deduct and withhold on such interest a tax equal to 20 percent of the amount thereof.

"(b) PAYEE UNKNOWN.—If the withholding agent is unable to determine the person to whom the interest is payable, the tax under this section shall be deducted and withheld at the time payment of the interest would be made if such person were known.

"(c) CROSS REFERENCES.—

"(1) For credit, against income tax of the recipient of the income, of amounts deducted and withheld under this section, see section 39.

"(2) For special rules as to credit or refund of such amounts, see sections 3484, 3485, 3486, 3487, and 3505.

"(3) For exemption from requirement of deducting and withholding on certain interest paid to certain persons, see section 3483.

"SEC. 3452. INTEREST DEFINED.

"(a) GENERAL RULE.—For purposes of this chapter, the term 'interest' means—

"(1) interest on evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a corporation with interest coupons or in registered form, and, to the extent provided in regulations prescribed by the Secretary or his delegate, interest on other evidences of indebtedness issued by a corporation of a type offered by corporations to the public;

"(2) interest on deposits with persons carrying on the banking business;

"(3) amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares;

"(4) interest on amounts held by an insurance company under an agreement to pay interest thereon;

"(5) interest on deposits with stockbrokers;

"(6) interest on obligations of the United States; and

"(7) in the case of a non-interest-bearing obligation of the United States—

"(A) issued on a discount basis, and

"(B) having a maturity date more than one year from the date of issue,

the amount by which the amount paid on surrender or redemption exceeds the issue price.

"(b) EXCEPTIONS.—For purposes of this chapter, the term 'interest' does not include—

"(1) interest on obligations described in section 103(a) (1) or (3) (relating to interest on certain governmental obligations);

"(2) any amount paid by—
"(A) a foreign government or international organization,
"(B) a foreign corporation not engaged in trade or business within the United States,
"(C) a nonresident alien individual not engaged in trade or business within the United States, or
"(D) a partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens;
"(3) interest on deposits with persons carrying on the banking business paid to a person described in paragraph (2) (B), (C), or (D);
"(4) any amount paid by one corporation to another corporation, if both corporations are members of the same affiliated group which filed a consolidated return for the preceding taxable year of the affiliated group;
"(5) interest subject to withholding under subchapter A of chapter 3 (sec. 1441 and following, relating to withholding of tax on nonresident aliens and foreign corporations) by the person paying such interst, or which would be so subject to withholding by such person, but for the fact that it is not treated as income from sources within the United States;
"(6) any amount on which the withholding agent is required to deduct and withhold a tax under section 1451 (relating to tax-free covenant bonds), or would be so required but for section 1541(d) (relating to benefit of personal exemptions);
"(7) to the extent provided in regulations prescribed by the Secretary or his delegate, any amount payable with respect to deposits in school savings accounts; and
"(8) any amoun described in subsection (a) (2), (3), and (7) paid to a State or a foreign government or international organization (other than any amount described in subsection (a)(3) paid in respect of a transferable certificate or share).
"(c) EXEMPTION FOR UNITED STATES.—The Secretary may authorize exemption from the tax imposed by section 3451 for any amount paid by the United States or any wholly owned agency or instrumentality thereof to the United States or any wholly owned agency or instrumentality thereof if the Secretary determines that the imposition of the tax with respect to such amount will cause a burden or expens which can be avoided by granting the tax exemption.

"Subchapter B—Dividends

"Sec. 3461. Income tax collected at source on dividends.
"Sec. 3462. Dividend defined.

"SEC. 3461. INCOME TAX COLLECTED AT SOURCE ON DIVIDENDS.

"(a) REQUIREMENT OF WITHHOLDING.—Except as otherwise provided in this chapter, every person who pays a dividend shall deduct and withhold on such dividend a tax equal to 20 percent of the amount thereof.
"(b) PAYEE UNKNOWN.—If the withholding agent is unable to determine the person to whom the dividend is payable, the tax under this section shall be deducted and withheld at the time payment of the dividend would be made if such person were known.
"(c) AMOUNT OF DIVIDEND UNKNOWN.—If the withholding agent is unable to determine the portion of a distribution which is a dividend, the tax under this section shall be computed on the entire amount of the distribution.
"(d) CROSS REFERENCES.—

"(1) For credit, against income tax of the recipient of the income, of amounts deducted and withheld under this section, see section 39.
"(2) For special rules as to credit or refund of such amounts, see sections 3484, 3485, 3486, 3487, and 3505.
"(3) For exemption from requirement of deducting and withholding on dividends paid to certain individuals, see section 3483.

"SEC. 3462. DIVIDEND DEFINED.

"(a) GENERAL RULE.—For purposes of this chapter, the term 'dividend' means—
"(1) any distribution by a corporation which is a dividend (as defined in section 316); and
"(2) any payment made by a stockbroker to any person as a substitute for a dividend (as so defined).
"(b) EXCEPTIONS.—For purposes of this chapter, the term 'dividend' does not include—

"(1) any amount paid in the stock, or rights to acquire the stock, of the distributing corporation if the disribution is not includible in gross income of the recipient under the provisions of section 305 (relating to distributions of stock and stock rights);

"(2) any distribution to the extent that, under chapter 1—

"(A) the amount thereof is treated by the recipient as an amount received on the sale or exchange of property, or

"(B) gain or loss to the recipient is not recognized;

"(3) any amount which is includible in gross income as a taxable dividend by reason of the provisions of section 302 (relating to redemptions of stock), 306 (relating to dispositions of certain stock), 356 (relating to recepit of additional consideration in connection with certain reorganizations), or 1081(e)(2) (relating to certain distributions pursuant to order of the Securities and Exchange Commission);

"(4) any amount paid by one corporation to another corporation, if both corporations are members of the same affiliated group which filed a consolidated return for the preceding taxable year of the affiliated group;

"(5) an amount which—

"(A) is subject to withholding under subchapter A of chapter 3 (sec. 1441 and following, relating to withholding of tax on nonresident aliens and foreign corporations) by the person paying such amount, or

"(B) would be subject to withholding under such subchapter A by the person paying such amount but for—

"(i) the fact that it is attributable to income from sources outside the United States, or

"(ii) the fact that the payor thereof is excepted from the application of section 1441(a) by the provisions of section 1441(c);

"(6) any amount paid by a foreign corporation not engaged in trade or business within the United States;

"(7) any amount described in section 1373 (relating to undisturbed taxable income of electing small business corporations); and

"(8) amounts paid pursuant to the terms of a lease entered into before January 1, 1954, if under such lease the shareholders of the lessor corporation are entitled to such amounts without deduction for any tax which any law of the United States might require to be deducted and withheld on the payment of dividends.

"Subchapter C—Patronage Dividends

"Sec. 3471. Income tax collected at source on patronage dividends.
"Sec. 3472. Amounts subject to withholding.

"SEC. 3471. INCOME TAX COLLECTED AT SOURCE ON PATRONAGE DIVIDENDS.

"(a) Requirement of Withholding.—Except as otherwise provided in this chapter, every cooperative to which part I of subchapter T of chapter 1 applies which pays an amount described in section 3472 shall deduct and withhold on such amount a tax equal to 20 percent of such amount.

"(b) Payee Unknown.—If the withholding agent is unable to determine the person to whom the amount is payable, the tax under this section shall be deducted and withheld at the time payment of the amount would be made if such person were known.

"(c) Cross References.—

"(1) For credit, against income tax of the recipient of the income, of amounts deducted and withheld under this section, see section 39.

"(2) For special rules as to credit or refund of such amounts, see sections 3484, 3485, 3486, 3487, and 3505.

"(3) For exemption from requirement of deducting and withholding on amounts paid to certain individuals, see section 3483.

"SEC. 3472. AMOUNTS SUBJECT TO WITHHOLDING.

"(a) General Rule.—Except as otherwise provided in this section or section 3483, the amounts subject to deduction and withholding under section 3471 are—

"(1) the amount of any patronage dividend (as defined in section 1388(a)) which is paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation as defined in section 1388(d)), and

"(2) any amount, described in section 1382(c) (2) (A) (relating to certain nonpatronage distributions), which is paid in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation by an organization exempt from tax under section 521 (relating to exemption of farmers' cooperatives from tax).

"(b) EXCEPTIONS.—The provisions of section 3471 shall not apply to—

"(1) any amount paid by one corporation to another corporation, if both corporations are members of the same affiliated group which filed a consolidated return for the preceding taxable year of the affiliated group;

"(2) an amount which—

"(A) is subject to withholding under subchapter A of chapter 3 (sec. 1441 and following, relating to withholding of tax on nonresident aliens and foreign corporations) by the person paying such amount, or

"(B) would be subject to withholding under such subchapter A by the person paying such amount but for the fact that it is attributable to income from sources outside the United States; and

"(3) any amount paid by a foreign corporation not engaged in trade or business within the United States.

"(c) EXEMPTION FOR CERTAIN CONSUMER COOPERATIVES.—A cooperative which the Secretary or his delegate determines is primarily engaged in selling at retail goods or services of a type that are generally for personal, living, or family use shall, upon application to the Secretary or his delegate, be granted exemption from the tax imposed by section 3471. Application for exemption under this subsection shall be made in accordance with regulations prescribed by the Secretary or his delegate.

"(d) DETERMINATION OF AMOUNT PAID.—For purposes of this subchapter, in determining amounts paid—

"(1) property (other than a written notice of allocation) shall be taken into account at its fair market value, and

"(2) a qualified written notice of allocation shall be taken into account at its stated dollar amount.

"Subchapter D—General Provisions

"Sec. 3481. Liability for return and payment of withheld tax.
"Sec. 3482. Return and payment by United States.
"Sec. 3483. Exemption certificates.
"Sec. 3484. Refund of tax to individuals.
"Sec. 3485. Refund of tax to States, tax-exempt organizations, etc.
"Sec. 3486. Refund of tax to corporation.
"Sec. 3487. Credit for tax withheld on corporation.
"Sec. 3488. Obligation sold between interest-payment dates.
"Sec. 3489. Presumption.
"Sec. 3490. Definitions.

"SEC. 3481. LIABILITY FOR RETURN AND PAYMENT OF WITHHELD TAX.

"(a) GENERAL RULE.—Every person required to deduct and withhold any tax under this chapter shall, on or before the last day of the first month following the close of each quarter of his taxable year, make a return of the tax required to be deducted and withheld during such quarter and pay the tax to the officer designated in section 6151. The withholding agent shall be liable for the payment of the taxes required to be deducted and withheld under this chapter, and shall not otherwise be liable to any person for the amount of any such payment.

"(b) TAX PAID BY RECIPIENT.—If the withholding agent, in violation of the provisions of this chapter, fails to deduct and withhold any tax under this chapter, and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld shall not be collected from the withholding agent; but this subsection shall in no case relieve the withholding agent from liability for any penalties or additions to the tax otherwise applicable in respect of such failure to deduct and withhold.

"(c) CROSS REFERENCE.—

"For limitation on the use of Government depositaries in the collection of taxes deducted and withheld under this chapter, see the last sentence of section 6302(c).

"SEC. 3482. RETURN AND PAYMENT BY UNITED STATES.

"If the withholding agent is the United States the return of the tax deducted and withheld under this chapter may be made by an officer or employee of the

United States having control of the payment of the amount subject to withholding, or appropriately designated for that purpose.

"SEC. 3483. EXEMPTION CERTIFICATES.

"(a) GENERAL RULES.—

"(1) INDIVIDUALS UNDER AGE 18.—Any individual may file with any withholding agent an exemption certificate on which he certifies the date of his birth. If such a certificate is filed, all amounts payable by such withholding agent to such individual, on and after the effective date for such certificate and before the beginning of the calendar year during which the certificate indicates that he will attain age 18, shall be exempt from the requirement of deducting and withholding under this chapter.

"(2) INDIVIDUALS OVER AGE 17.—Any individual may file with any withholding agent an exemption certificate on which he certifies—

"(A) that he will have attained age 18 before the close of the calendar year for which such certificate is filed, and

"(B) that he reasonably believes that he will not (after the application of the credits against tax provided by part IV of subchapter A of chapter 1, other than the credits under sections 31 and 39) be liable for the payment of any tax under chapter 1 for each of his taxable years any portion of which is included in the period for which such certificate will be in effect.

If such a certificate is filed, all amounts payable by such withholding agent to such individual during the period such certificate is in effect shall be exempt from the requirement of deducting and withholding under this chapter. Except as may otherwise be provided in regulations prescribed by the Secretary or his delegate, an exemption certificate filed by an individual described in this paragraph shall remain in effect only for the period beginning on the effective date of such certificate and ending at the close of the calendar year in which such period begins.

"(3) TAX-EXEMPT ORGANIZATIONS.—

"(A) Any organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 may file with any withholding agent who pays amounts described in section 3452(a) (2), (3), or (7) an exemption certificate on which it certifies that it is such an organization. If such a certificate is filed, all amounts described in section 3452(a) (2), (3), and (7) payable by such withholding agent to such organization on and after the effective date for such certificate shall (except as provided in subparagraph (B)) be exempt from the requirement of deducting and withholding under this chapter.

"(B) An exemption certificate filed by an organization under subparagraph (A) shall cease to be effective on the thirtieth day after the day on which the withholding agent, with whom such certificate was filed, is notified by either the organization or the Secretary or his delegate that the organization is no longer exempt from the tax imposed by chapter 1. If an organization ceases to be exempt from such tax, it shall, within the time specified in regulations prescribed by the Secretary or his delegate, so notify each withholding agent with whom it has an exemption certificate in effect.

"(b) EXCEPTIONS AND SPECIAL RULES.—

"(1) CERTAIN EXCEPTIONS.—This section shall not apply to any amount—

"(A) described in section 3452(a)(1) (relating to interest on evidences of indebtedness),

"(B) described in section 3452(a)(3) paid in respect of a transferable certificate or share, or

"(C) described in section 3452(a)(6) (relating to interest on obligations of the United States).

"(2) SERIES E BONDS, ETC.—In the case of transactions involving the redemption of one or more obligations described in section 3452(a)(7) (relating to certain obligations of the United States issued on a discount basis), a separate certificate shall be filed with respect to each such transaction.

"(3) NOMINEES, CUSTODIANS, AND JOINT OWNERSHIPS.—Under regulations prescribed by the Secretary or his delegate, the exemption provided by subsection (a) may be extended, in a manner consistent with the other provisions of this section, to—

"(A) amounts (other than amounts described in section 3462(a), relating to dividends) paid through nominees;
"(B) amounts paid to custodians; and
"(C) amounts paid jointly to 2 or more individuals.

"(4) EFFECTIVE DATE OF CERTIFICATE.—Any exemption certificate under this section shall take effect on such day as is specified in accordance with regulations prescribed by the Secretary or his delegate.

"(5) FORM AND CONTENTS OF CERTIFICATE AND NOTICE.—Any exemption certificate under this section, and any notice under subsection (a)(3)(B), shall be in such form and contain such information as the Secretary or his delegate may by regulations prescribe.

"(c) CROSS REFERENCE.—

"For penalty for filing fraudulent certificate, or for failing to provide notice, under this section, see section 7205.

"SEC. 3484. REFUND OF TAX TO INDIVIDUALS.

"(a) GENERAL RULE.—Except as provided in subsection (e), the tax deducted and withheld under this chapter with respect to amounts received by an individual during any quarter (other than the fourth quarter) of his taxable year (together with any tax so deducted and withheld on amounts which were received by him during any prior quarter of such year and with respect to which no allowable claim for refund has been filed under this section) shall, to the extent such tax does not exceed his refund allowance as of the time the claim for refund is filed, be promptly refunded to him as an overpayment of tax. A refund of tax shall be made under this section only if the amount claimed and allowable equals or exceeds $10.

"(b) REFUND ALLOWANCE.—For purposes of this section, the refund allowance of an individual as of the time the claim for refund is filed is an amount equal to the excess, if any, of—

"(1) an amount equal to 22 percent of—

"(A) the total of the deductions which, on the basis of facts existing at the time the claim for refund is filed, such individual would be allowed for the taxable year under section 151 (relating to deductions for personal exemptions), plus

"(B) in the case of an individual who, at the time the claim for refund is filed, reasonably expects that he will be allowed a credit under section 37 (relating to retirement income) for the taxable year, the amount which, at such time, such individual reasonably expects to be the amount of his retirement income (as defined in section 37(c) and as limited by section 37(d)) for the taxable year, less

"(C) the amounts (other than amounts on which tax is required to be deducted and withheld under this chapter) which, at the time the claim for refund is filed, such individual reasonably expects to be includible in his gross income for the taxable year; over

"(2) the amounts of tax with respect to which an allowable claim for refund has been previously filed under this section during the taxable year.

For purposes of paragraph (1)(C), an individual who files more than one claim for refund under this section for any taxable year may use the estimate for the preceding claim for such year unless, at the time he files the claim, he reasonably expects the amounts referred to in paragraph (1)(C) to exceed such prior estimate by more than $100.

"(c) MARRIED INDIVIDUALS.—For purposes of subsections (a), (b), and (d), married individuals shall be treated as an individual if, at the time the claim for refund is filed, they reasonably expect that they will file a joint return for the taxable year in which such claim is filed.

"(d) TIME FOR FILING CLAIM.—Not more than one claim may be filed under this section by any individual during any quarter of his taxable year. A refund of tax deducted and withheld on amounts received during a taxable year shall be made under this section only if claim therefor is filed on or before the last day of such taxable year.

"(e) INDIVIDUALS NOT ELIGIBLE FOR REFUND.—No claim for refund may be filed under this section by—

"(1) any individual (other than an individual referred to in paragraph (2) or (3)) unless, at the time the claim for refund is filed, he reasonably expects that his gross income for the taxable year will not exceed $5,000;

"(2) any married individual unless, at the time the claim for refund is filed, he reasonably expects that the aggregate gross income of such individual and his spouse for the taxable year will not exceed $10,000;

"(3) a head of a household (as defined in section 1(b)(2)) or a surviving spouse (as defined in section 2(b)) unless, at the time the claim for refund is filed, he reasonably expects that his gross income for the taxable year will not exceed $10,000; or

"(4) any child, unless, at the time the claim for refund is filed, he reasonably expects that no deduction would be allowed for him under section 151 (e)(1)(B) for the taxable year of his parent (or parents) beginning with or within the calendar year in which the claim for refund is filed.

"(f) CROSS REFERENCE.—

"For credit or refund of amounts not refunded under this section, see section 39.

"SEC. 3485. REFUND OF TAX TO STATES, TAX-EXEMPT ORGANIZATIONS, ETC.

"(a) GENERAL RULE.—In the case of a person which is—

"(1) the United States or a State,

"(2) an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1,

"(3) a foreign government or international organization, or

"(4) a foreign central bank of issue,

if the tax deducted and withheld under this chapter with respect to amounts received by such person during any calendar quarter exceeds the credit, if any, claimed by and allowable to such person under section 3505 (relating to credit against employment taxes) for such quarter, the excess (together with any such excess for any prior quarter of the same calendar year with respect to which no refund has been claimed and allowed under this section) shall be promptly refunded or credited to such person as an overpayment of tax. In the case of a person to which paragraph (4) applies, the amount which may be refunded or credited under this section shall not exceed the amount of tax deducted and withheld under section 3451 on interest paid on obligations of the United States which are not held for, or used in connection with, the conduct of commercial banking functions or other commercial activities.

"(b) CROSS REFERENCES.—

"(1) For period of limitation for filing claim under this section, see section 6511.

"(2) For presumed date of payment for purposes of (A) period of limitation, see section 6513(b), and (B) allowance of interest on overpayments, see section 6611(d).

"SEC. 3486. REFUND OF TAX TO CORPORATION.

"(a) GENERAL RULE.—If the tax deducted and withheld under this chapter with respect to amounts received by a corporation (other than a corporation described in section 3485(a)) during any quarter (other than the fourth quarter) of its taxable year exceeds the amount claimed by and allowable to such corporation under section 3487 as a credit against its liability for tax under this chapter for such quarter, the excess (together with any such excess for any prior quarter of the same year with respect to which no refund has been claimed and allowed under this section) shall be promptly refunded or credited to such corporation as an overpayment of tax. A refund of tax shall be made under this section only if claim therefor is filed after the close of the period covered by the claim and on or before the last day of the taxable year.

"(b) CROSS REFERENCE.—

"For credit or refund of amounts not refunded under this section, see section 39.

"SEC. 3487. CREDIT FOR TAX WITHHELD ON CORPORATION.

"(a) GENERAL RULE.—Any tax deducted and withheld under this chapter with respect to amounts received by a corporation (other than a corporation described in section 3485(a)) during a taxable year shall, to the extent not claimed and allowable as a credit or refund to the corporation under section 3486, be allowed, under regulations prescribed by the Secretary or his delegate, as a credit against (but not in excess of) the tax for which such corporation is liable under this chapter in respect of amounts paid by it during such year.

"(b) DIVIDENDS AND PATRONAGE DIVIDENDS PAID DURING TAXABLE YEAR.—For purposes of determining the credit allowable to any corporation under subsection (a), a dividend, or amount subject to withholding under section 3471, paid by it may be considered as having been paid during the taxable year—

"(1) in the case of a personal holding company, if treated as paid during such taxable year under section 563(b),

"(2) in the case of a regulated investment company, if treated as paid during such taxable year under section 855(a),

"(3) in the case of a real estate investment trust, if treated as paid during such taxable year under section 858(a), or

"(4) in the case of a cooperative described in section 1381(a), if paid during the payment period (as defined in section 1382(d)) for such taxable year.

"(c) SPECIAL RULE FOR CORPORATIONS WHICH ARE MEMBERS OF AN AFFILIATED GROUP.—To the extent and subject to such conditions as may be provided in regulations prescribed by the Secretary or his delegate, the tax deducted and withheld under this chapter with respect to amounts received by a corporation which is a member of an affiliated group which filed a consolidated return for the preceding taxable year of the affiliated group may, for purposes of this section, be treated as tax deducted and withheld under this chapter from any corporation which is a member of the same affiliated group.

"SEC. 3488. OBLIGATION SOLD BETWEEN INTEREST-PAYMENT DATES.

"For purposes of any credit or refund provided in section 3484, 3485, 3486, or 3487, in the case of an obligation which is sold or exchanged between interest-payment dates the amount required to be deducted and withheld on the interest at the end of the interest-payment period shall be treated in the manner provided in section 39(c).

"SEC. 3489. PRESUMPTION.

"For purposes of establishing that any person is entitled to a credit or refund of any tax required to be deducted and withheld under this chapter with respect to amounts received by such person, the correct amount of such tax shall, in the absence of evidence to the contrary, be presumed to have been so deducted and withheld.

"SEC. 3490. DEFINITIONS.

"For purposes of this chapter—

"(1) PERSON.—The term 'person' includes the United States, a State, a foreign government, and an international organization.

"(2) STATE.—The term 'State' includes a State, the District of Columbia, a possession of the United States, any political subdivision of any of the foregoing, and any wholly owned agency or instrumentality of any one or more of the foregoing.

"(3) FOREIGN GOVERNMENT.—The term 'foreign government' includes a foreign government, a political subdivision of a foreign government, and any wholly owned agency or instrumentality of any one or more of the foregoing.

"(4) NONRESIDENT ALIEN.—The term 'nonresident alien individual' includes an alien resident of Puerto Rico."

(2) CLERICAL AMENDMENTS, ETC.—

(A) The heading for subtitle C is amended to read as follows:

"Subtitle C—Employment Taxes and Collection of Income Tax at Source"

(B) The table of chapters for subtitle C is amended by striking out the last line and inserting in lieu thereof the following:

"CHAPTER 25. Collection of income tax at source on interest, dividends, and patronage dividends.
"CHAPTER 26. General provisions relating to employment taxes and collection of income taxes at source."

(C) The table of subtitles under the heading "Internal Revenue Title" at the beginning of the Internal Revenue Code of 1954 is amended by striking out the third line and inserting in lieu thereof the following:

"SUBTITLE C. Employment taxes and collection of income tax at source."

(D) The heading for chapter 26 (as redesignated by pargaraph (1) of this subsection) is amended to read as follows:

"CHAPTER 26—GENERAL PROVISIONS RELATING TO EMPLOYMENT TAXES AND COLLECTION OF INCOME TAXES AT SOURCE"

(b) CREDITS AGAINST INCOME TAX FOR TAX WITHHELD.—

(1) ALLOWANCE OF CREDIT.—Part IV of subchapter A of chapter 1 (relating to credits against tax) is amended by inserting after section 38 (added by section 2 of this Act) the following new section:

"SEC. 39. TAX WITHHELD ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS.

"(a) GENERAL RULE.—Under regulations prescribed by the Secretary or his delegate, the tax deducted and withheld under chapter 25 (relating to withholding at source on interest, dividends, and patronage dividends) shall be allowed, to the recipient of the amount with respect to which such tax was deducted and withheld, as a credit against the tax imposed by this subtitle for the taxable year in which such amount is received.

"(b) SPECIAL RULE FOR DEPENDENT CHILDREN.—If—

"(1) the taxpayer for his taxable year is entitled to a deduction under section 151(e)(1)(B) with respect to a child, and

"(2) such child had, for the calendar year ending with or within the taxpayer's taxable year—

"(A) gross income of less than $600, and

"(B) no wages (as defined in section 3401(a)) with respect to which withholding was required under chapter 24,

then, under regulations prescribed by the Secretary or his delegate, the taxpayer shall be entitled to the credit provided by subsection (a) with respect to amounts received by such child during such calendar year, but only if such child has not filed any claim for credit or refund of any portion of the tax deducted and withheld with respect to such amounts.

"(c) APPORTIONMENT OF CREDIT.—For purposes of subsection (a), if an obligation is sold or exchanged between interest-payment dates—

"(1) so much of the amount required to be deducted and withheld on the interest at the end of the interest-payment period as is properly allocable to that part of such period which ends on the date of the sale or exchange shall be treated as an amount deducted and withheld from the transferor on the date of the sale or exchange, and

"(2) so much of such amount as is properly allocable to that part of such period which begins on the day after the date of the sale or exchange shall be treated as an amount deducted and withheld from the transferee.

"(d) LIMITATIONS.—The credit provided by subsection (a) shall not be allowed—

"(1) REFUND TO INDIVIDUALS.—To any individual with respect to any amount of tax allowed him as a refund under section 3484.

"(2) CREDIT OR REFUND TO STATES, ETC.—To any person with respect to any amount of tax allowable to such person as a credit or refund under section 3485 or as a credit under section 3505.

"(3) CREDIT OR REFUND TO CORPORATIONS.—To any person with respect to any amount of tax allowed such person as a credit or refund under section 3486 or as a credit under section 3487.

"(4) CERTAIN DEPENDENT CHILDREN.—To any person with respect to any amount of tax which has been claimed and is allowable as a credit to such person's parent by reason of the provisions of subsection (b).

"(5) NOMINEES, ETC.—To any person with respect to any amount of tax allowed such person as a credit under section 1444(b)."

(2) COMMON TRUST FUNDS.—Section 584(c) (relating to the income of participants in the fund) is amended by adding at the end thereof the following paragraph:

"(3) TAX WITHHELD AT SOURCE ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS.—In any case where tax under chapter 25 is deducted and withheld on any amounts received by a common trust fund, for purposes of any credit or refund provided in section 39 or 3505, or chapter 25, such tax shall, in accordance with regulations prescribed by the Secretary or his delegate, be considered as having been deducted and withheld proportionately from each participant."

(3) ESTATES AND TRUSTS.—Section 642(a) (relating to special rules for credits and deductions in the case of estates and trusts) is amended by adding at the end thereof the following new paragraph:

"(4) TAX WITHHELD AT SOURCE ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS.—In any case where tax under chapter 25 is deducted and withheld on any amounts received by an estate or trust, for purposes of any credit or refund provided in section 39 or 3505, or chapter 25, such tax shall, in accordance with regulations prescribed by the Secretary or his delegate, be considered as having been deducted and withheld from each beneficiary in an amount which, when added to the amounts paid, credited, or required to be distributed to him, equals the amounts which would have been paid, credited, or required to be distributed to him in the absence of chapter 25. Any tax under chapter 25 which is deducted and withheld on amounts received by the estate or trust shall be considered as withheld from such estate or trust to the extent it is not considered as withheld from a beneficiary under the provisions of the preceding sentence."

(4) TECHNICAL AMENDMENTS.—

(A) Section 164(b)(1) (relating to deduction denied in the case of certain taxes) is amended by—

(i) striking out the word "and" at the end of subparagraph (B);

(ii) striking out the comma at the end of subparagraph (C) and inserting "; and"; and

(iii) adding after subparagraph (C) the following new subparagraph:

"(D) the tax withheld at source under chapter 25 (relating to collection of income tax at source on interest, dividends, and patronage dividends),".

(B) Section 874(a) (relating to allowance of deductions and credits to nonresident alien individuals) is amended by striking "31 and 32" and inserting in lieu thereof "31, 32, and 39".

(C) Section 1314(e) (relating to inapplicability of part II of subchapter Q of chapter 1 of subtitle A to taxes imposed by subtitle C) is amended by striking "employment taxes" and inserting in lieu thereof "employment taxes and collection of income tax at source".

(D) Section 6211(b)(1) (relating to rules applicable in determination of deficiency) is amended by striking "31" and inserting in lieu thereof "31 or 39".

(E) The table of sections for part IV of subchapter A of chapter 1 is amended by striking out

"Sec. 38. Overpayments of tax."

and inserting in lieu thereof

"Sec. 38. Investment in certain depreciable property.
"Sec. 39. Tax withheld on interest, dividends, and patronage dividends.
"Sec. 40. Overpayments of tax."

(c) INTEREST AND DIVIDENDS PAID TO NONRESIDENT ALIENS, ETC.—

(1) WITHHOLDING RATE.—

(A) Section 1441 (relating to withholding of tax on nonresident aliens) is amended by adding at the end thereof the following new subsection:

"(e) TREATIES.—In the case of amounts described in section 3452(a) (relating to interest), section 3462(a) (relating to dividends), and section 3472(a) (relating to patronage dividends), the tax required to be deducted and withheld under subsection (a) shall not by reason of the provisions of any treaty be less than 20 percent of such amounts."

(B) Section 1442 (relating to withholding of tax on foreign corporations) is amended by adding at the end thereof the following new sentence: "In the case of amounts described in section 3452(a) (relating to interest), section 3462(a) (relating to dividends), and section 3472 (a) (relating to patronage dividends), the tax required to be deducted and withheld under the preceding sentence shall not by reason of the provisions of any treaty be less than 20 percent of such amounts."

(2) NOMINEES, ETC.—Subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and foreign corporations) is amended by adding at the end thereof the following new section:

"SEC. 1444. INTEREST AND DIVIDENDS PAID TO NOMINEES; CREDITS TO WITHHOLDING AGENTS.

"(a) WITHHOLDING OF TAX BY PAYOR.—Under regulations prescribed by the Secretary or his delegate, every person who pays amounts subject to withholding under chapter 25 and who has been notified by a payee thereof that the payee is a nominee required to deduct and withhold on such amounts under section 1441 or 1442 shall, in lieu of the nominee, deduct and withhold from such amounts paid to the nominee the tax required to be deducted and withheld under section 1441 or 1442, in the same manner as if such amounts were paid by such person directly to the beneficial owner thereof.

"(b) CREDITS TO WITHHOLDING AGENTS.—In the case of any person who is required to deduct and withhold tax under section 1441 or 1442 in respect of amounts received by him during any calendar year on which tax was deducted and withheld (or, in the case of amounts described in section 39(c)(1), was treated as deducted and withheld) under chapter 25, the taxes so deducted and withheld (or treated as deducted and withheld) under chapter 25 shall, under regulations prescribed by the Secretary or his delegate, be allowed as a credit against (but not in excess of) his liability for the year in respect of the taxes imposed by sections 1441 and 1442."

(3) CLERICAL AMENDMENT.—The table of sections for subchapter A of chapter 3 is amended by adding at the end thereof the following:

"Sec. 1444. Interest and dividends paid to nominees; credits to withholding agents."

(d) CREDIT FOR STATES AND TAX-EXEMPT ORGANIZATIONS.—

(1) ALLOWANCE OF CREDIT.—Chapter 26 (general provisions relating to employment taxes and income tax withheld at source) is amended by adding at the end thereof the following new section:

"SEC. 3505. SPECIAL CREDIT IN CASE OF STATES OR TAX-EXEMPT ORGANIZATIONS.

"(a) GENERAL RULE.—In the case of a person which is a State (as defined in section 3490(2)) or which is an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1, the tax deducted and withheld under chapter 25 with respect to amounts received by it during any calendar quarter shall be allowed, under regulations prescribed by the Secretary or his delegate, as a credit against (but not in excess of) such person's liability (after the adjustments, if any, provided for in sections 6205(a) and 6413(a)) for such quarter in respect of the taxes imposed by chapter 21 (Federal Insurance Contributions Act) and by chapter 24 (collection of income tax at source on wages). Such credit shall be allowed only if claim therefor is made, in accordance with such regulations, at the time of the filing of the return with respect to the taxes under chapter 21 and chapter 24 for such quarter.

"(b) OBLIGATIONS SOLD BETWEEN INTEREST-PAYMENT DATES.—For purposes of this section, in the case of an obligation which is sold or exchanged between interest-payment dates, the amount required to be deducted and withheld on the interest at the end of the interest-payment period shall be treated in the manner provided in section 39(c).

"(c) CROSS REFERENCE.—

"For refund under chapter 25, see section 3485."

(2) TECHNICAL AMENDMENTS.—

(A) Section 3502 (relating to nondeductibility of taxes in computing taxable income) is amended by adding at the end thereof the following new subsection:

"(c) The tax deducted and withheld under chapter 25 shall not be allowed as a deduction in computing taxable income under subtitle A either to the person deducting and withholding the tax or to the recipient of the amounts subject to withholding."

(B) The table of sections for chapter 26 is amended by adding at the end thereof the following:

"Sec. 3505. Special credit in case of States or tax-exempt organizations."

(e) OTHER TECHNICAL AMENDMENTS.—

(1) DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS.—Section 6015(a) (relating to declaration of estimated income tax by individuals) is amended by striking out the period at the end of paragraph (2) and inserting in lieu thereof "and amounts on which tax is required to be dededucted and withheld under chapter 25".

(2) ADJUSTMENT OF TAX UNDERPAYMENT.—

(A) Subsection (a)(1) of section 6205 (relating to special rules relating to assessment of employment taxes) is amended by striking out "or 3402 is paid with respect to any payment of wages or compensation," and inserting in lieu therof "3402, 3451, 3461, or 3471 is paid with respect to any payment of remuneration, interest, dividends, or other amounts".

(B) Subsection (b) of such section is amended by striking out "or 3402 is paid or deducted with respect to any payment of wages or compensation" and inserting in lieu thereof "3402, 3451, 3461, or 3471 is paid or deducted with respect to any payment of remuneration, interest, dividends, or other amounts".

(C) The heading for such section is amended to read as follows:

"SEC. 6205. SPECIAL RULES APPLICABLE TO CERTAIN TAXES UNDER SUBTITLE C."

(D) the table of section for subchapter A of chapter 63 is amended by striking out

"Sec. 6205. Special rules applicable to certain employment taxes."

and inserting in lieu thereof

"Sec. 6205. Special rules applicable to certain taxes under subtitle C."

(3) USE OF GOVERNMENT DEPOSITARIES.—Section 6302(c) (relating to use of Government depositaries) is amended by adding at the end thereof the following new sentence: "The Secretary or his delegate shall not require the deposit under this subsection of any tax deducted and withheld under chapter 25 (relating to collection of income tax at source on interest, dividends, and patronage dividends) in a Government depositary before the last day prescribed in section 3481 for payment of the tax."

(4) EXCESSIVE WITHHOLDING.—Section 6401(b) (relating to excessive withholding) is amended to read as follows:

"(b) EXCESSIVE WITHHOLDING.—If the amounts allowable as credits under section 31 (relating to credit for tax withheld at source under chapter 24) and section 39 (relating to credit for tax withheld on interest, dividends, and patronage dividends under chapter 25) exceed the taxes imposed by chapter 1 against which such credits are allowable, the amount of such excess shall be considered an overpayment."

(5) ADJUSTMENT OF TAX; OVERPAYMENT.—

(A) Subsection (a)(1) of section 6413 (relating to special credit and refund rules applicable to certain employment taxes) is amended by striking out "or 3402 is paid with respect to any payment of remuneration," and inserting in lieu thereof "3402, 3451, 3461, or 3471 is paid with respect to any payment of remuneration, interest, dividends, or other amounts,".

(B) Subsection (b) of such section is amended—

(i) By striking from the heading of such subsection the words "OF CERTAIN EMPLOYMENT TAXES"; and

(ii) By striking out "or 3402 is paid or deducted with respect to any payment of remuneration" and inserting in lieu thereof "3402, 3451, 3461, or 3471 is paid or deducted with respect to any payment of remuneration, interest, dividends, or other amounts".

(C) The following new subsection is added at the end of such section:

"(e) CROSS REFERENCES.—

"For special refunds or credits of tax withheld on interest, dividends, or patronage dividends under chapter 25, see sections 3484, 3485, 3486, 3487, and 3505."

(D) The heading for such section is amended to read as follows:

"SEC. 6413. SPECIAL RULES APPLICABLE TO CERTAIN TAXES UNDER SUBTITLE C."

(E) The table of sections for subchapter B of chapter 65 is amended by striking out

"Sec. 6413. Special rules applicable to certain employment taxes."

and inserting in lieu thereof

"Sec. 6413. Special rules applicable to certain taxes under subtitle C."

(6) OVERPAYMENT NOT DEDUCTED AND WITHHELD.—Section 6414 (relating to income tax withheld) is amended by striking "chapter 3" and inserting in lieu thereof "chapter 3 or 25".

(7) TIME TAX CONSIDERED PAID.—Section 6513(b) (relating to time tax considered paid) is amended by adding at the end thereof the following new sentences: "For purposes of section 6511 or 6512, any tax deducted and withheld under chapter 25 which is allowable under section 39, 3484, 3485, or 3486 as a credit against tax or as a refund of an overpayment (or an amount treated as an overpayment) of the tax imposed by chapter 1 shall, in respect of the person entitled to such credit or refund, be deemed to have been paid by him on the last day prescribed for filing the return (determined without regard to any extension of time for filing such return) of tax under chapter 1 for his taxable year in which the amount subject to withholding under chapter 25 is received by him or, if such person has no taxable year, on the fifteenth day of the fifth calendar month following the close of such person's annual accounting period within which such amount is received by him. In the case of an amount allowable as a credit under section 39(b) to the parent of a child, such amount shall, if claimed by the parent, be deemed to have been paid on the last day for filing his return (determined without regard to any extension of time for filing such return) for his taxable year which begins with or within the calendar year in which amounts subject to withholding under chapter 25 were received by the child."

(8) FAILURE TO PAY ESTIMATED INCOME TAX.—

(A) INDIVIDUALS.—Subsections (e) and (f) of section 6654 (relating to failure by individual to pay estimated income tax) are amended to read as follows:

"(e) APPLICATION OF SECTION IN CASE OF WITHHELD TAXES.—For purposes of applying this section—

"(1) the estimated tax shall be computed without any reduction for amounts which the individual estimates as his credits under section 31 (relating to tax withheld at source on wages) and section 39 (relating to tax withheld on interest, dividends, and patronage dividends); and

"(2) the amount of the credits allowed under sections 31 and 39 for the taxable year shall be deemed a payment of estimated tax, and an equal part of such amount shall be deemed paid on each installment date (determined under section 6153) for such taxable year, unless the taxpayer establishes the dates on which all amounts were actually withheld (or in the case of amounts described in section 39(c)(1), were treated as withheld), in which case the amounts so withheld shall be deemed payments of estimated tax on such dates.

"(f) TAX COMPUTED AFTER APPLICATION OF CREDITS AGAINST TAX.—For purposes of subsections (b) and (d), the term 'tax' means the tax imposed by chapter 1 reduced by the credits against tax allowed by part IV of subchapter A of chapter 1, other than the credits against tax provided by section 31 (relating to tax withheld on wages) and section 39 (relating to tax withheld on interest, dividends, and patronage dividends)."

(B) CORPORATIONS.—Section 6655 (relating to failure by corporation to pay estimated income tax) is amended—

(i) by striking out the period at the end of subsection (e)(2)(B) and inserting in lieu thereof ", other than the credit against tax provided by section 39 (relating to tax withheld on interest, dividends, and patronage dividends)."; and

(ii) by redesignating subsection (f) as subsection (g) and inserting after subsection (e) the following new subsection:

"(f) APPLICATION OF SECTION IN CASE OF TAX WITHHELD ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS.—For purposes of applying this section—

"(1) the estimated tax shall be computed without any reduction for the amount which the corporation estimates as its credit under section 39 (relating to tax withheld on interest, dividends, and patronage dividends); and

"(2) the amount of the credit allowed under section 39 for the taxable year shall be deemed a payment of estimated tax, and an equal part of such amount shall be deemed paid on each installment date (determined under section 6154) for such taxable year, unless the corporation establishes the dates on which all amounts were actually withheld (or in the case of amounts described in section 39(c)(1), were treated as withheld), in which case the amounts so withheld shall be deemed payments of estimated tax on such dates."

(9) PENALTY FOR FILING FRAUDULENT EXEMPTION CERTIFICATE.—Section 7205 (relating to fraudulent withholding exemption certificate or failure to supply information) is amended by adding the following new sentence at the end thereof: "Any person who willfully files an exemption certificate with any withholding agent under section 3483, on which the certification is known by him to be fraudulent or to be false as to any material matter, or who is required to file a notice under subsection (a)(3)(B) of section 3483 and who willfully fails to provide such notice in the manner, at the, time and showing the information required under such subsection (a)(3)(B), or the regulations prescribed thereunder, shall in lieu of any penalty otherwise provided, upon conviction thereof, be fined not more than $500, or imprisoned not more than 1 year, or both."

(10) OFFENSES WITH RESPECT TO COLLECTED TAXES.—The last sentence of section 7215(b) (relating to offenses with respect to collected taxes) is amended to read as follows: "For purposes of paragraph (2), a lack of funds existing immediately after the payment of wages or amounts subject to withholding under chapter 25 (whether or not created by the payment of such wages or amounts) shall not be considered to be circumstances beyond the control of a person."

(11) DEFINITION OF WITHHOLDING AGENTS.—Section 7701(a)(16) (defining the term "withholding agent") is amended by striking out "or 1461" and inserting in lieu thereof "1461, 3451, 3461, or 3471".

(f) EFFECTIVE DATES.—

(1) GENERAL RULE.—Except as provided in paragraph (2), the provisions of this section shall apply in the case of interest and dividends paid on or after January 1, 1963.

(2) SPECIAL RULES.—

(A) In the case of transferable obligations described in paragraph (1) or (6) of section 3452(a) of the Internal Revenue Code of 1954, the provisions of this section shall apply only to interest paid with respect to interest-payments periods commencing on or after January 1, 1963.

(B) The provisions of this section shall apply to amounts described in section 3472 of such Code paid on or after January 1, 1963, with respect to patronage occurring on or after the first day of the first taxable year of the cooperative beginning on or after January 1, 1963.

SEC. 20. INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES.

(a) INFORMATION TO BE FURNISHED BY INDIVIDUALS, DOMESTIC CORPORATIONS, ETC., WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS.—Section 6038 is amended to read as follows:

"SEC. 6038. INFORMATION WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS.

"(a) REQUIREMENT.—

"(1) IN GENERAL.—Every United States person shall furnish, with respect to any foreign corporation which such person controls (within the meaning of subsection (d)(1)), such information as the Secretary or his delegate may prescribe by regulations relating to—

"(A) the name, the principal place of business, and the nature of business of such foreign corporation, and the country under whose laws incorporated;

"(B) the accumulated profits (as defined in section 902(c)) of such foreign corporation, including the items of income (whether or not included in gross income under chapter 1), deductions (whether or not

allowed in computing taxable income under chapter 1), and any other item taken into account in computing such accumultaed profits;

"(C) a balance sheet for such foreign corporation listing assets, liabilities, and capital;

"(D) transactions between such foreign corporation and—

"(i) such person,

"(ii) any other corporation which such person controls, and

"(iii) any United States person owning, at the time the transaction takes place, 10 percent or more of the value of any class of stock outstanding of such foreign corporation; and

"(E) a description of the various classes of stock outstanding, and a list showing the name and address of, and number of shares held by, each United States person who is a shareholder of record owning at any time during the annual accounting period 5 percent or more in value of any class of stock outstanding of such foreign corporation.

The Secretary or his delegate may also require the furnishing of any other information which is similar or related in nature to that specified in the preceding sentence.

"(2) PERIOD FOR WHICH INFORMATION IS TO BE FURNISHED, ETC.—The information required under paragraph (1) shall be furnished for the annual accounting period of the foreign corporation ending with or within the United States person's taxable year. The information so required shall be furnished at such time and in such manner as the Secretary or his delegate shall by regulations prescribe.

"(3) LIMITATION.—No information shall be required to be furnished under this subsection with respect to any foreign corporation for any annual accounting period unless such information was required to be furnished under regulations in effect on the first day of such annual accounting period.

"(b) EFFECT OF FAILURE TO FURNISH INFORMATION.—

"(1) IN GENERAL.—If a United States person fails to furnish, within the time prescribed under paragraph (2) of subsection (a), any information with respect to any foreign corporation required under paragraph (1) of subsection (a), then—

"(A) in applying section 901 (relating to taxes of foreign countries and possessions of the United States) to such United States person for the taxable year, the amount of taxes (other than taxes reduced under subparagraph (B)) paid or deemed paid (other than those deemed paid under section 904(d)) to any foreign country or possession of the United States for the taxable year shall be reduced by 10 percent, and

"(B) in applying sections 902 (relating to foreign tax credit for corporate stockholder in foreign corporation) and 957 (relating to special rules for foreign tax credit) to any such United States person which is a corporation (or to any person who acquires from any other person any portion of the interest of such other person in any such foreign corporation, but only to the extent of such portion) for any taxable year, the amount of taxes paid or deemed paid by each foreign corporation with respect to which such person is required to furnish information during the annual accounting period or periods with respect to which such information is required under paragraph (2) of subsection (a) shall be reduced by 10 percent.

If such failure continues 90 days or more after notice by the Secretary or his delegate to the United States person, then the amount of the reduction under this subsection shall be 10 percent plus an additional 5 percent for each 3-month period, or fraction thereof, during which such failure to furnish information continues after the expiration of such 90-day period.

"(2) SPECIAL RULES.—

"(A) No taxes shall be reduced under this subsection more than once for the same failure.

"(B) For purposes of this subsection, the time prescribed under paragraph (2) of subsection (a) to furnish information (and the beginning of the 90-day period after notice by the Secretary) shall be treated as being not earlier than the last day on which (as shown to the satisfaction of the Secretary of his delegate) reasonable cause existed for failure to furnish such information.

"(C) In applying subsections (a) and (b) of section 902, and in applying subsection (a) of section 956, the reduction provided by this subsection shall not apply for purposes of determining the amount of accumulated profits in excess of income, war profits, and excess profits taxes.

"(c) TWO OR MORE PERSONS REQUIRED TO FURNISH INFORMATION WITH RESPECT TO SAME FOREIGN CORPORATION.—Where, but for this subsection, two or more United States persons would be required to furnish information under subsection (a) with respect to the same foreign corporation for the same period, the Secretary or his delegate may by regulations provide that such information shall be required only from one person. To the extent practicable, the determination of which person shall furnish the information shall be made on the basis of actual ownership of stock.

"(d) DEFINITIONS.—For purposes of this section—

"(1) CONTROL.—A person is in control of a corporation if such person owns stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or more than 50 percent of the total value of shares of all classes of stock, of a corporation. If a person is in control (within the meaning of the preceding sentence) of a corporation which in turn owns more than 50 percent of the total combined voting power of all classes of stock entitled to vote of another corporation, or owns more than 50 percent of the total value of the shares of all classes of stock of another corporation, then such person shall be treated as in control of such other corporation. For purposes of this paragraph, the rules prescribed by section 318(a) for determining ownership of stock shall apply; except that clause (i) of section 318(a)(2)(C) shall be applied without regard to the 50 percent limitation contained in such section.

"(2) ANNUAL ACCOUNTING PERIOD.—The annual accounting period of a foreign corporation is the annual period on the basis of which such corporation regularly computes its income in keeping its books.

"(e) CROSS REFERENCES.—

"(1) For provisions relating to penalties for violations of this section, see section 7203.

"(2) For definition of the term 'United States person', see section 7701(a)(30)."

(b) INFORMATION AS TO ORGANIZATION OF REORGANIZATION OF FOREIGN CORPORATIONS AND AS TO ACQUISITIONS OF THEIR STOCK.—Section 6046 (relating to returns as to creation or organization, or reorganization, of foreign corporations) is amended to read as follows:

"SEC. 6046. RETURNS AS TO ORGANIZATION OR REORGANIZATION OF FOREIGN CORPORATIONS AND AS TO ACQUISITIONS OF THEIR STOCK.

"(a) REQUIREMENT OF RETURN.—A return complying with the requirements of subsection (b) shall be made by—

"(1) each United States citizen or resident who is an officer or director of a foreign corporation on January 1, 1963, or who becomes such an officer or director at any time after such date,

"(2) each United States person who on January 1, 1963, owns 5 percent or more in value of the stock of a foreign corporation, or who, at any time after such date—

"(A) acquires stock which, when added to any stock owned on January 1, 1963, has a value equal to 5 percent or more of the value of the stock of a foreign corporation, or

"(B) acquires an additional 5 percent or more in value of the stock of a foreign corporation, and

"(3) each person who at any time after January 1, 1963, becomes a United States person while owning 5 percent or more in value of the stock of a foreign corporation.

"(b) FORM AND CONTENTS OF RETURNS.—The returns required by subsection (a) shall be in such form and shall set forth, in respect of the foreign corporation, such information as the Secretary or his delegate prescribes by forms or regulations as necessary for carrying out the provisions of the income tax laws.

"(c) OWNERSHIP OF STOCK.—For purposes of subsection (a) (2) and (3), stock owned directly or indirectly by a person (including, in the case of an individual, stock owned by members of his family) shall be taken into account. For purposes of the preceding sentence, the family of an individual shall be considered as including only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

"(d) TIME FOR FILING.—Any return required by subsection (a) shall be filed on or before the 90th day after the day on which, under any provision of subsection (a), the United States citizen, resident, or person becomes liable to file such return.

"(e) CROSS REFERENCE.—

"For provisions relating to penalties for violations of this section, see sections 6678 and 7203."

(c) CIVIL PENALTY FOR FAILURE TO FILE RETURN.—Subchapter B of chapter 68 (relating to assessable penalties) is amended by adding at the end thereof the following new section:

"SEC. 6678. FAILURE TO FILE RETURNS AS TO ORGANIZATION OR REORGANIZATION OF FOREIGN CORPORATIONS AND AS TO ACQUISITIONS OF THEIR STOCK.

"(a) CIVIL PENALTY.—In addition to any criminal penalty provided by law, any person required to file a return under section 6046 who fails to file such return at the time provided in such section, or who files a return which does not show the information required pursuant to such section, shall pay a penalty of $1,000, unless it is shown that such failure is due to reasonable cause.

"(b) DEFICIENCY PROCEDURES NOT TO APPLY.—Subchapter B of chapter 63 (relating to deficiency procedure for income, estate, and gift taxes) shall not apply in respect of the assessment or collection of any penalty imposed by subsection (a)."

(d) TECHNICAL AMENDMENTS.—

(1) Section 318(b) (relating to cross references) is amended by striking out "and" at the end of paragraph (5), by striking out the period at the end of paragraph (6) and inserting in lieu thereof "; and", and by adding at the end thereof the following:

(7) section 6038(d)(2) (relating to information with respect to certain foreign corporations)."

(2) The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by striking out

"Sec. 6046. Returns as to creation or organization, or reorganization, of foreign corporations."

and inserting in lieu thereof

"Sec. 6046. Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock."

(3) The table of sections for subchapter B of chapter 68 is amended by adding at the end thereof the following:

"Sec. 6678. Failure to file returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock."

(e) EFFECTIVE DATE.—

(1) The amendments made by subsection (a) shall apply with respect to annual accounting periods of foreign corporations beginning after December 31, 1962.

(2) The amendments made by subsection (b) shall take effect on January 1, 1963.

SEC. 21. TREATIES.

Section 7852(d) of the Internal Revenue Code of 1954 (relating to treaty obligations) shall not apply in respect of any amendment made by this Act.

Passed the House of Representatives March 29, 1962.

Attest:

RALPH R. ROBERTS, *Clerk.*

The CHAIRMAN. The first witness is Secretary Dillon. Secretary Dillon had an engagement to go down to South America tomorrow but he canceled it because of the revolution. [Laughter.]

I am very glad he did because he is a very valuable man in the official family of the Government, and I think he should protect himself and not go where there is any danger of being killed.

Mr. Dillon, you may proceed.

STATEMENT OF HON. DOUGLAS DILLON, SECRETARY OF THE TREASURY

Secretary DILLON. Mr. Chairman, as you have pointed out, this is a highly complex bill which covers a great many items and, therefore, my statement which must cover these, all of these items, at least in some detail, is longer than I would ordinarily like to have a statement, and I beg your indulgence for that.

During my appearance before you this morning, I hope that I shall be able to convey my strong personal feeling of urgency concerning the need for favorable action on the balanced tax revision bill so painstakingly constructed by the House Ways and Means Committee.

H.R. 10650, entitled "The Revenue Act of 1962," was passed by the House of Representatives last Thursday. This forward-looking measure was developed on the basis of the tax recommendations contained in the President's message to the Congress of April 20, 1961.

The President pointed out in his message that although the basic framework of our tax system is generally acceptable, constructive reforms are essential to insure that it serves our changing domestic and international economic goals and that it continues to meet the requirements of tax fairness in a changing economy.

The bill before you incorporates most of the President's recommendations, although some of them in modified form. The House Ways and Means Committee merits high commendation for its thoughtful and truly prodigious efforts over the past 11 months. Those efforts have produced a bill that moves the tax structure a considerable distance in the directions sought by the President and at the same time provides a modest revenue gain.

I appreciate being able to discuss with you the features of the bill which I consider satisfactory as well as our recommendations for improvements. I will not follow the order in which these features are taken up in the bill. The sequence used in the bill does not group related subjects together but rather takes up sections in accordance with the order in which they will appear in the Internal Revenue Code. Thus, I will depart from this sequence in order to treat related items in close conjunction with one another.

TAX CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY (SEC. 2)

The central element in the bill is the tax credit for investment in depreciable machinery and equipment. The bill provides in general for the deduction from taxes otherwise due of 7 percent of the cost of new machinery and equipment. A similar result could have been achieved by a 14 percent investment allowance, under which 14 percent of the investment would be deductible in computing taxable income. This method of investment stimulation is presently in use in the United Kingdom, Belgium, and the Netherlands and is in the process of being enacted by the Australian Parliament. It is a tried and proven approach. We have preferred the 7 percent tax credit to the 14 percent investment allowance because it gives full credit to small businesses subject to the 30 percent corporate tax rate and to those unincorporated businesses whose tax rate is less than 52 percent. With an investment allowance a small business would receive only 30

percent of the benefit compared to 52 percent for larger companies. With a tax credit the full benefit flows to small businesses. The credit will apply to investment in eligible assets acquired after December 31, 1961. It will stimulate investment in modernization and expansion of our industrial capacity, strengthen our whole economy, contribute to economic growth, and substantially increase the competitiveness of American products in markets at home and abroad.

American industry must compete in a world of diminishing trade barriers, in which the advantages of a vast market, so long enjoyed here in the United States, are now being or are about to be realized by many of our foreign competitors. Our balance of payments position, as well as our standard of living in the long run, can be improved or even maintained only if we can increase our efficiency and productivity at a rate at least equal to that of other leading industrialized nations. These nations have now largely achieved the conditions needed to attract massive investment in productive facilities—including external currency convertibility, price stability, and political stability—and they are providing effective tax incentives designed to accelerate investment and growth. We cannot, therefore, afford to stand by and do nothing, or put off affirmative action to a later day. We need to increase our investment in machinery and equipment now—delay can only place greater strains on our international payments position and put off the achievement of the rate of growth we must achieve if we are to meet our domestic and international commitments and provide jobs for our ever-increasing labor force.

Machinery and equipment expenditures—the type of business capital expenditure which is basic to the creation of new products and which also makes the most direct contribution to cost-cutting, productivity, and efficiency—constitute a smaller percentage of the gross national product in the United States than in any major industrial nation of the world. In recent years we have devoted less than 6 percent of our GNP (less than 5 percent in 1961) to this type of vital capital outlay, only half the proportion devoted to this purpose by West Germany, only three-fourths that of the United Kingdom, and about 60 percent as much as the combined average of the European members of the OECD. Perhaps even more significant is the fact that in the United States this percentage has recently been declining steadily, whereas it has been increasing in these other nations.

Recent studies indicate a close correlation between the ratio of investment in productive equipment to GNP and the rate of economic growth. In view of the relatively small proportion of GNP that has been allocated to investment in machinery and equipment in the United States, it is not surprising to find that the average annual rate of growth (in constant prices) experienced in the United States

in the decade of the fifties was only 3 percent, compared with more than 7 percent for West Germany, and with a range of 4 to 6 percent for most other industrial countries of Western Europe. In order to minimize unemployment, to satisfy the desire of our people for rising standards of living, to meet our defense and other domestic and international obligations, and to demonstrate the vitality of our free economy, we must achieve a higher rate of growth. This we cannot do unless we achieve a more satisfactory rate of capital formation.

We cannot hope to achieve the increased rate of capital formation necessary to more rapid economic growth and full employment unless we bring our tax treatment of capital investment into line with the standards which our European competitors have used so successfully over the past decade. To attain this result the administration is pursuing a two-pronged course in the area of depreciation. One step involves administrative action to modernize depreciation guidelines in keeping with the statutory provision of a "reasonable allowance" for depreciation, including obsolescence. In addition to more realistic recognition of obsolescence and technological trends, the Treasury aims to achieve a simpler, more flexible system of depreciation.

The revised depreciation guidelines, to be announced in late spring of this year, will constitute the first really major change in the administration of depreciation since the early 1930's. The establishment of a modern depreciation system which takes account of the current faster tempo of obsolescence will help to stimulate investment in this country. But, I must emphasize, the shortening of depreciable lives to a fully realistic basis will not bring American industry abreast of its foreign competitors. For all the other major industrialized nations of the free world provide for either the use of unrealistically short lives for depreciation purposes, a practice which distorts income and cost statements, or for special initial allowances or investment allowances which supplement regular depreciation charges, or for a combination of two or more of these incentives.

The impact of depreciation plus initial and investment allowances on the amounts that may be deducted in the year in which a new asset

is acquired in Canada, Japan, and the seven leading industrial nations of Western Europe is shown in table 1:

TABLE 1.—*Comparison of depreciation deductions, initial and investment allowances*[1] *for industrial equipment in leading industrial countries with similar deductions and allowances in the United States*

	Representative tax lives	Depreciation deductions, initial and investment allowances (percentage of cost of asset)		
		First year	First 2 years	First 5 years
	Years			
Belgium	8	22.5	45.0	92.5
Canada	10	30.0	44.0	71.4
France	10	25.0	43.8	76.3
West Germany	10	20.0	36.0	67.2
Italy	10	25.0	50.0	100.0
Japan	16	43.4	51.0	68.2
Netherlands	10	26.2	49.6	85.6
Sweden	5	30.0	51.0	100.0
United Kingdom	27	39.0	46.3	64.0
Unied States:				
Without investment credit and lives equal to current Bulletin F weighted average of 19 years		10.5	19.9	42.7
With lives of:				
15 years		13.3	24.9	51.1
14 years		14.3	26.5	53.7
13 years		15.4	28.4	56.6
12 years		16.7	30.6	59.8
11 years		18.2	33.1	63.0
10 years		20.0	36.0	67.2
With investment credit and lives equal to current Bulletin F weighted average of 19 years[2]		(24.5) 26.5	(33.9) 35.9	(56.7) 58.7
With lives of:				
15 years		(27.3) 29.3	(38.9) 40.9	(65.1) 67.1
14 years		(28.3) 30.3	(40.5) 42.5	(67.7) 69.7
13 years		(29.4) 31.4	(42.4) 44.4	(70.6) 72.6
12 years		(30.7) 32.7	(44.6) 46.6	(73.8) 75.8
11 years		(32.2) 34.2	(47.1) 49.1	(77.0) 79.0
10 years		(34.0) 36.0	(50.0) 52.0	(81.2) 83.2

[1] The deductions and allowances for each of the foreign countries have been computed on the assumption that the investment qualifies fully for any special allowances or deductions permitted. The deductions in the United States have been determined under the double-declining balance depreciation method, without regard to the limited first-year allowances for small business.

[2] For purposes of this table, the 8 percent investment credit has been considered as equivalent to a 16 percent investment allowance. For corporations subject only to the 30 percent normal tax it is equivalent to an investment allowance of 27 percent. The figures in parentheses indicate the effect of a 7-percent credit, equivalent to an investment allowance of 14 percent (23 percent for corporations subject only to the normal tax).

Source: Treasury Department, Office of Tax Analysis, Apr. 2, 1962.

Here it may be seen that the percentage of the cost of an asset that may be deducted in the first year ranges from 20 percent in West Germany to 43.4 percent in Japan compared with as low as 10.5 percent in the United States. For the first 5 years of the life of the asset, the relevant proportion falls within the range of 62–70 percent for West Germany, Japan, and the United Kingdom, between 70 and 80 percent for Canada and France, and 85 to as much as 100 percent for Beligum, Italy, the Netherlands, and Sweden. In sharp contrast, the applicable percentage in the United States is 42.7 under the present average Bulletin "F" life and 51.1 percent for the most commonly used 15-year life.

The data presented in the table demonstrate clearly that even a drastic downward revision of depreciable lives beyond anything that can be justified by realistic asset lives would still not bring capital allowances in the United States to a level comparable with that per-

mitted by our foreign competitors. Should our overall administrative revision of depreciation bring about reductions in guideline lives as large as those which were found appropriate for the textile industry, not more than a quarter of the current gap between depreciation practices here and abroad will be closed. Administrative modernization of depreciation simply cannot do the job. The reason is simple. Realistic depreciation cannot be expected to produce depreciation chargeoffs equal to the special incentive provisions in general use abroad. Nor can it provide the additional incentive which the experience of other industrialized countries has demonstrated is needed to broaden and deepen the flow of investment into new, more efficient equipment. The combination of both the forthcoming modernization of depreciation guidelines and a special incentive such as the investment credit contained in the bill before you is required if U.S. business firms are to be placed on substantially equal footing with their foreign competitors in this respect. It is essential to our competitive position in markets, both here, at home, and abroad, that American industry be put on the same basis as foreign industry. Unless this is done, increased imports and decreased exports will unnecessarily add to the burden of our balance-of-payments deficit.

The investment credit will stimulate investment in a number of ways. Because it reduces the net cost of acquiring depreciable assets it increases the rate of profitability. Thus, for example, a 10-year asset that is expected to yield a rate of return after taxes of 5 percent under straight line or 5.6 percent under double-declining balance depreciation will, with an 8-percent investment credit, yield a return of 7.9 percent per year. This represents an increase in profitability of more than 40 percent (for a 7-percent credit the 7.9 and 40 percent become 7.6 and 35 percent). An increase of this magnitude will provide a major stimulus to business firms to replace older, less efficient machinery and equipment and, in the process, incorporate the most recent technological developments into productive facilities. Detailed explanations of the procedures involved in computing profitability and the cost of the various incentive measures that have been suggested at one time or another are contained in exhibit I.

Investment decisions are influenced as well by the availability of funds. Since the credit will increase the flow of cash available for investment, it will stimulate investment through this effect as well as through its effect on profitability. The increased cash flow will be particularly important for new and smaller firms, which do not have ready access to the capital markets and whose growth is often restrained by a lack of capital funds.

Still another way in which the credit may be expected to stimulate investment is through a reduction in the payoff period for investment in a particular asset, which is one measure of the risk associated with any investment. This reduction in risk, coupled with the higher rate of profitability and increased cash flow, will shift the margin at which positive decisions to invest are made and will help to restore to past levels the proportion of our annual output that is devoted, through investment in machinery and equipment, to building the strength, vitality, and competitive force of the American economy.

Another interesting comparison may be made, one that should intrigue those who favor a low-interest rate as a primary investment stimulus. An 8-percent investment credit reduces the gross financing costs of a 10-year asset as much as would a reduction of the interest rate from 5 to 3⅓ percent, for a 15-year asset from 5 to 3⅔ percent. But the credit does not entail the balance of payments and other difficulties that would accompany a concerted effort to bring long-term interest rates down by such a large extent.

Some critics of the investment credit have suggested that we should approach the problem of increasing investment through tax changes by giving first priority to measures designed to add to consumer demand. An increase in consumer demand will, of course, induce additional investment, but this is not the only way in which the level of investment may be raised and it would be wrong to place our entire reliance on this approach. This is because investment induced by consumer demand suggests primarily expansion using existing kinds of equipment and techniques, rather than more efficient and larger quantities of capital per worker and, therefore, greater productivity. We cannot be content merely with the level of capital formation that will result from response to increased consumer demand. We must have both more capital equipment per unit of output and increased demand for that output. Thus a higher rate of growth requires a more rapid accumulation of productive facilities than would be forthcoming if investment were induced solely by an increase in final demand. The American economy now is much in need of modernization of its capital equipment which, in the technological environment of the 1960's, requires an increase in the ratio of capital to output. One of the important means of achieving a higher rate of economic growth lies precisely in increasing this ratio, and a direct approach to investment incentives is needed to accomplish this. We must increase the overall attractiveness of investment at any given volume of consumer demand in order that our productivity and growth may be maximized.

With this objective in mind, the credit should be viewed primarily as a means of encouraging the modernization of industrial mining, agricultural, and other equipment, increasing the productivity of the American economy by adding to the quantity and quality of capital available per worker, and increasing the relative attractiveness of investment at home compared with investment abroad.

Those who are properly concerned about the existing gap between current and full employment output urge that this gap should be filled by expansion of consumer demand. But the increase in overall demand required to bring the economy closer to full employment need not consist solely of an increase in consumer demand. Increased investment adds equally to aggregate demand, and in the transition to full employment the rising aggregate demand due to increased investment will, by transmitting itself through the economy, add substantially to consumer demand.

Moreover, in this transition period the total increase in demand—generated by increased investment but including additional outlays on consumer goods and services—will far exceed any overall increase in capacity. Thus the credit will contribute significantly to our objective of achieving a higher level of employment. It should be clearly

noted that the increased productive capacity resulting from a more rapid rate of capital formation will also in the long run make possible for higher levels of consumption.

Another objection to the investment credit stems from concern about our ability to maintain full utilization of the increased productive capacity after it has been acquired. I believe that this concern reflects a viewpoint that is far too pessimistic. The underlying forces of expansion in our economy are strong and will be strengthened further by the enactment of the investment credit. The substantial anticipated increase in the labor force in the years ahead provides a challenge and an opportunity, if the necessary tools of production are forthcoming, for a more rapid rate of economic growth than we have experienced in recent history. I am confident that this administration will take such steps as are needed to maintain the required level of total demand. The economic effects of the investment credit will make its task easier. It is in the context of this approach to public policy that the merits of the investment credit must be appraised.

Another criticism which was heard frequently last year was based on a misunderstanding. This was the thought that the credit is a temporary remedy for recession or that it would be somehow offset by more restrictive administration of depreciation. The arguments I have made for the credit clearly reveal that such legislation must be a permanent part of our tax code if we are to meet foreign competition, and our administrative action in the textile field is a harbinger of what is being prepared for other fields—more liberal rather than more restrictive administrative action.

Finally there has been the criticism that holds that the credit is a form of subsidy which other incentive measures are not and that it will not be sufficiently effective as a means of increasing investment. Those who hold this view, including the National Association of Manufacturers, usually favor the acceleration of depreciation beyond what is justified on the basis of realistic accounting. Careful study and consideration of a wide variety of alternatives to the investment credit show, however, that all of these alternatives, without exception, share the same characteristic of giving the investor in equipment a monetary reward beyond what he would receive on the basis of realtistic accounting. The element of subsidy or incentive is equally present in all of them. We have chosen the credit primarily because it increases the profitability of investment far more per dollar of revenue cost than any of the other alternatives. For example, the first 5 years' revenue cost of a 20-percent initial allowance would exceed that of an 8-percent investment credit by about $1 billion, but the allowance would increase the profitability of investment in a 10-year asset by less than 10 percent, compared with more than 40 percent for the investment credit. Even a 40-percent initial allowance, the cost of which over the next 5 years would be more than twice as great as the cost of the credit, would have an appreciably smaller effect on profitability for assets with expected useful lives of up to 20 years.

Similar conclusions emerge from our analysis of such incentives as triple-declining balance depreciation and across-the-board percentage increases in depreciation allowances. In addition all of these alternatives which go beyond realistic depreciation suffer from a

number of important disadvantages which are not associated with the investment credit. Unrealistically high depreciation charges tend to distort income accounting and produce higher costs for tax and, in the case of a great number of firms, book purposes. Such higher costs may frequently be reflected in higher prices. Since they also cost the Government more and provide a lesser stimulus to investment, it seems clear that the investment credit is the best way in which to supply the additional incentive that is so badly needed.

In general, the House bill carries out the President's recommendation on the investment credit in an acceptable manner. As you know, however, the general rate of the investment credit was reduced in the final stage of House consideration of the bill from 8 to 7 percent in order to achieve an overall revenue balance in the bill. At the same time the House reduced the limit on the credit allowable against tax liability in any taxable year from the first $100,000 plus 50 percent of the excess to $25,000 plus 25 percent. Although a 7-percent credit would provide a substantial stimulus to investment, the 8-percent figure was originally chosen because it produced the maximum stimulus consistent with our revenue needs. I therefore urge the committee to restore the credit to the original level as reported by the Ways and Means Committee. It would also be helpful if the committee would restore the limitation over $25,000 to the 50 percent figure originally adopted by the Ways and Means Committee. These two changes can be accomplished at a gross cost of $375 million, which would be more than offset by other changes in the bill which I shall suggest. In order to reduce the revenue cost of the credit for fiscal year 1963 I recommend that the 25-percent limit be retained for the current year. This would hold the gross increase in cost for fiscal year 1963 to $135 million, which would be more than offset by other reductions in the cost of the credit itself which I shall suggest.

Under the House bill the credit can be taken on up to $50,000 a year in used equipment which otherwise meets the tests of eligibility. This feature is intended to aid small businesses, which frequently purchase used equipment. It should help those smaller firms with limited capital resources which seek to upgrade their equipment by replacing wholly obsolete assets with used but more recent models. At the same time adequate safeguards are provided to insure against abuses that might otherwise arise as a consequence of fictitious trading in used assets.

H.R. 10650 provides a partial credit of 3 percent with respect to otherwise qualified outlays by regulated public utilities such as electric power, gas, and telephone companies. The full credit is allowed transportation companies which do not enjoy the monopoly privileges of the other utilities and whose rates are not regulated in a manner designed to permit a specific rate of return for each company. The full credit is also allowed to gas pipelines.

The President's original proposal recommended that the credit not apply to regulated public utility corporations. This recommendation was made with full recognition of the great contribution the utilities make to the American economy. It was based on the fact that public utilities are regulated monopolies with substantial assurance of a given rate of return on investment after tax. Moreover, investment in public utility facilities is based largely on demand, governed by public requirements.

After evaluating serious conflicting considerations, the Ways and Means Committee and the House adopted a compromise position, granting a 3-percent rather than a 7-percent credit to eligible investments of the utilities. While we recognize that industrial power costs are an important element in manufacturing costs, we have not been able to separate this element of the utility business from the regulated fields of commercial and household consumption. For this reason and for the reasons more fully set out in exhibit I, the Treasury considers that on balance the issue would be better resolved through the exclusion of the regulated utilities in the electric, gas, and communications fields. The Federal Power Commission has informed us that the gas pipelines share the basic characteristics of these regulated utilities and would be treated for ratemaking purposes in the same manner. For this reason gas pipelines should be grouped with other regulated public utilities and be excluded from qualification for the credit.

The revenue gain from exclusion of these utilities from the credit in the House bill would amount to more than $250 million. With the changes I have suggested the annual gross cost of the investment credit when fully operable will be $1,350 million, based on the level of investment anticipated for 1962.

I should like to make a few concluding comments on the investment credit proposal before passing on to other aspects of the bill. Throughout our economy there will be thousands of investment decisions involving billions of dollars during the remainder of this year and in succeeding years which may hinge on the outcome of this legislation. There is often a thin line between a yes and no decision in the investment area. With the credit we will have affirmative actions where there would otherwise be none.

This matter has top priority in the agenda for tax reform. As chief financial officer of the Nation, I do not lightly regard tax abatements on the scale proposed here. I urge this legislation because it will make a real addition to growth consistent with the principles of a free economy; because it will provide substantial help in alleviating our balance-of-payments problem, both by substantially increasing the relative attractiveness of domestic as compared with foreign investment and by helping to improve the competitive position of American industry in markets at home and abroad; and because, far from adding to the forces responsible for alternative recessions and recoveries, it will be of major assistance in strengthening our present recovery and enabling us to attain a higher rate of growth and sustained full employment. Early action will resolve uncertainty or hesitancy and begin at once a strong and lasting incentive for modernization of the productive facilities of our national economy.

The rest of the bill and our further recommendations will bring substantial improvements in tax equity and will more than offset the gross cost of an 8-percent investment credit.

GAINS FROM THE DISPOSITION OF DEPRECIABLE PROPERTY (SEC. 14)

The President recommended that capital gain treatment be withdrawn from gains on the disposition of depreciable property, both real and personal, to the extent of prior depreciation allowances.

Such gain reflects depreciation allowances in excess of the actual decline in value of the asset and under the President's proposal would be treated as ordinary income. Any gain in excess of the cost of the asset would still be treated as capital gain. This reform would eliminate an unfair tax advantage which the law today gives to those who depreciate property at a rate in excess of the actual decline in market value and then proceed to sell the property, thus, in effect, converting ordinary income into a capital gain. It is particularly essential at this time in view of the impending administrative revision of depreciation guidelines.

Under H.R. 10650 gain on the disposition of depreciable personal property, and certain other property which is eligible for the investment credit, will be treated as ordinary income to the extent of depreciation taken for taxable years beginning after December 31, 1961.

However, the House failed to act on the President's proposal as it applies to real estate, largely because of difficulties in reaching a consensus on the appropriate remedy. There nevertheless appears to be recognition that excessive depreciation in the real estate area is a serious problem and that some action is required.

It is my view that it would be unwise to delay action. I therefore renew the recommendation for legislation at this time. Specifically I recommend that depreciation, with respect to all real estate hereafter acquired, be limited to an amount not in excess of the depreciation allowed under the straight-line method. Under present rules depreciation at accelerated rates applies not only to the taxpayer's investment, but also to the amount of mortgage indebtedness to which the property is subject. Since the acquisition of real estate is usually heavily financed by mortgage indebtedness, accelerated depreciation often provides deductions far in excess of the income from the property. In such cases the investor is able, because of the depreciation deduction, to amortize the principal of the mortgage, to obtain a nontaxable cash return of 10 to 12 percent or more on his equity investment, and even to wipe out tax on other income at top bracket rates. When the depreciation deductions cease to produce such spectacular results, the property is frequently sold. Thus the excess depreciation, having been charged against income taxable at ordinary rates, is recouped and taxed only as capital gains.

Concrete examples of this process are contained in exhibit VI.

Furthermore, accelerated depreciation applied to real estate is not an appropriate measure of decline in value. Real estate, unlike personal property, does not generally suffer unusually heavy depreciation in the early years of its life.

In addition, gain on the sale of all real estate should be treated as ordinary income to the extent of depreciation for taxable years beginning after December 31, 1961. To meet the assertion of real estate investors that such ordinary income treatment would operate peculiarly in the real estate area to lock them into their investments after a long period of time, such treatment could be subject to a sliding scale cutoff as follows: In the case of real estate held for 6 years or less at time of disposition, gain would be ordinary income to the extent of 100 percent of depreciation for taxable years beginning after December 31, 1961, in the case of real estate held for more than 6 years prior to disposition, the percentage of such depreciation which

would be treated as ordinary income would be reduced by one percentage point for each month the property has been held in addition to 6 years.

A sliding scale cutoff, starting as early as 6 years after acquisition, is appropriate only if depreciation of real estate is limited to the straight-line method. Even with straight-line depreciation, taxation of gain on the sale of depreciable real estate at ordinary income rates to the extent of prior depreciation is necessary for at least the period provided in the sliding scale cutoff. This will relieve the pressure on depreciable lives that would otherwise obtain and will permit more flexibility to the taxpayer. It will therefore limit disputes in the determination of tax lives, salvage values, and expenditures allowable as repair deductions for depreciable real estate.

The House bill also should be amended to provide for the treatment as ordinary income of gain on the sale of depreciable property to the extent of prior deductions for amortization of interests in depreciable property, in order to prevent avoidance of this section by the use of leaseholds of depreciable property.

The revenue gain to be realized from the enactment of the House bill's provision for taxation of gain on the sale of depreciable property is $100 million. Adding the features I have recommended with respect to real estate will add a further $80 million to our tax receipts.

EXPENSE ACCOUNTS (SEC. 4)

One of the most publicized and troublesome areas in our tax system today is the deductible expense account. The problem is not simply one of the tax avoidance that arises through abuse of existing rules, such as disguising as business expense the entertainment and recreational activities of members of the family or the gross overestimating of expenditures on business entertainment. The requirement in the House bill that entertainment, traveling, and gift expenses be properly substantiated represents an effective step forward in controlling this abuse. But even where business associates are involved and proper records are kept, present law allows members of a select group to charge a large portion of their recreational and personal living expenses to the Federal Government.

Tighter enforcement of present law is not the answer to the problem. Under present law the use of a yacht to entertain acquaintances ostensibly to seek potential business, or wining and dining acquaintances in night clubs and at cocktail parties for similar purposes, can be charged against income otherwise taxable. This confers substantial tax-free personal benefits upon those offering the entertainment and the beneficiaries of the entertainment. Personal expenses disguised as business expenses present difficult enforcement problems. Only clear-cut decisive legislation will remedy this ever-worsening situation, with its unfortunate effects on the morale of the general taxpayer and on tax revenues.

Originally in the House and today before this committee, we urge that the cost of business entertainment, including club dues, and the maintenance of entertainment facilities (such as yachts and hunting lodges) be disallowed in full as a tax deduction. Restrictions should also be imposed on the amount to be deducted as business gifts, and on travel expenses for vacations that are combined with business travel.

To permit the normal conduct of business affairs, a number of important exceptions should be provided. Thus, deductions should not be denied for the cost of meals in surroundings conducive to business discussions, employee recreational programs, entertainment extended to the public in general, and similar items, as set forth in the House bill.

As it relates to entertainment and facilities, H.R. 10650 it designed to require a closer connection between the entertainment and the carrying on of business activities. While this will enable the Internal Revenue Service to disallow the cost of entertaining which is not directly related to the actual conduct of business, the House provision obviously draws only a vaguely defined line. It seems certain that considerable controversy and litigation will ensue.

Moreover, the House approach does not fully solve the basic problem. It still permits the deduction, for a relatively small and select group, of expenditures which, unlike other business expenses, confer substantial personal benefits upon their recipients.

As regards gifts, the House provision denying deductions for business gifts having a value of more than $25 would effectively curb present abuses.

The bill before you will also effect an improvement in the area of travel expenses if, as we assume, the standard of "reasonableness" inserted in the statutory provisions dealing with the deduction of traveling expenses, is intended to curtail lavish and extravagant expenditures. However, the bill fails to provide for any allocation of traveling expenses when a trip is devoted partly to business and partly to vacation; deduction of the total expenses of such travel is a serious abuse problem today and a reasonable allocation provision is needed.

In its present form, the expense-account features of H.R. 10650 will add $125 million per year to tax receipts. Adoption of the provisions we are now recommending will increase this figure to $250 million.

WITHHOLDING OF INCOME TAX AT SOURCE ON INTEREST AND DIVIDENDS (SEC. 19)

An obvious defect in our tax system lies in the failure of some individuals to report dividend and interest income on their tax returns. Most dividend and interest recipients are responsible taxpayers who faithfully report each year about $15 billion of such income. There is, however, about $3 billion of interest and dividends received by taxable individuals which is not reported. That shortage results in a revenue loss of more than $800 million annually, which must be made up by the general taxpayer.

This nonreporting of dividends and interest is a chronic problem which must be dealt with effectively. Billions of dollars in Government revenues have been lost over the years and the substantial, continuing avoidance of tax in this area has a demoralizing effect.

The Government has not let this problem go unchallenged. Strong efforts have been made, with the full support and cooperation of the financial community, to improve voluntary compliance through educational drives. The Internal Revenue Service has enlarged its audit enforcement and educational activities in this area. But the overall results have been disappointing.

It has been suggested that in the future, with automatic data processing, additional information reporting by interest and dividend payers, and more audit enforcement effort, the nonreporting gap might be closed. This approach has been carefully studied by our tax administrators. But the failure to report dividends and interest is a mass compliance problem involving millions of transactions and ADP, although helpful in the sorting of information documents filed by payers, will not, in itself, collect any taxes. To collect taxes by this procedure would require an inordinate amount of time, manpower, and money in audit-followup and collection procedures as well as the use of at least 250 million information returns. Moreover, at best, the Government could be expected to recover only a small portion of the unpaid taxes which, though large in total, represent an aggregation of a large number of rather small sums.

The Commisioner of Internal Revenue has concluded that the ADP-enforcement approach alone, as compared to withholding "would be burdensome and expensive to business and Government out of all proportion to the effect it would have on the reporting gap." He estimates that, even with a substantially enlarged enforcement and collection effort, based upon greatly expanded reporting by payers of interest, this approach would only reduce the nonreporting gap by about 25 percent, as compared to 80 percent for withholding. At the same time, withholding will cost the Service about one-third less—$19 million, as compared with $27 million.

The Commissioner regards withholding as "the most workable, business-like approach" for closing the gap, by assuring the automatic colection of tax at the first tax bracket rate. ADP, as a system complementary to withholding, can be efficiently and effectively applied to assist in achieving tax compliance in the higher income brackets.

The President's recommendation for tax withholding does not involve a new tax on dividend and interest income; it is simply an administrative device to assure collection of existing tax obligations. We have had tax withholding on wages and salaries for almost two decades. It is a proven tax collection method—helpful not only to the Government but also to taxpayers as a gradual and systematic method of tax payment and collection. Since most dividend and interest recipients also are, or have been, wage and salary earners, withholding on dividends and interest would in large part cover taxpayers already familiar with withholding operations. The House bill provides for exemptions from withholding for most interest and dividends receivable by all children under 18 years of age and for adults who do not expect to owe any tax. It also provides for prompt quarterly refunds in all cases involving overwithholding.

The mechanics of withholding on dividends and interest will be simple. The institution paying the dividends and interest will merely total up the amount of dividends or interest due to persons who have not filed exemption certificates, deduct 20 percent of this total amount, and pay the 20 percent over to the Government at the end of the month following the quarter in which the dividends or interest are paid. It will pay each dividend or interest recipient who has not filed an exemption certificate 80 percent of the amount of his dividend or interest. It will not be necessary for payers to furnish information statements either to the Government or to the recipient of dividends

or interest. Persons who have filed exemption certificates will be paid the full amount of the dividend or interest.

Dividend and interest withholding is equally simple for the recipient. Since withholding will always be at a flat 20-percent rate, the recipient can easily determine how much has been withheld. In fact, the recipient does not even have to know how much has been withheld in order to complete his tax return. The return will carefully lead him through a simple gross-up procedure whereby he can determine the amount of his dividends and interest to be included in his income and the credit he is allowed for the amount of tax withheld.

The mechanics of the Treasury's original withholding proposal, with no provision for exemption certificates, were even simpler. The Ways and Means Committee after full consideration, however, decided that a system of exemption certificates for nontaxable individuals is more desirable. Although this will mean some additional record keeping for payers, the House felt that the benefits of an exemption procedure clearly outweigh the additional work involved.

The withholding provisions of H.R. 10650, which would be made effective on January 1, 1963, meet the President's objective in this area. It is estimated that the withholding system provided in the bill will recoup $650 million of the annual revenue loss resulting from the nonreporting of dividends and interest.

PROVISIONS INVOLVING TAX EQUALITY AMONG COMPETING BUSINESSES

1. TAX TREATMENT OF COOPERATIVES AND PATRONS (SEC. 17)

Legislation enacted by the Congress in 1951 was intended to tax cooperative income on a current basis at the cooperative level if the income was not paid out or allocated as patronage dividends, or at the patron level, if it was paid out or allocated. As the result of court decisions which held that certain noncash patronage refunds are nontaxable when received by patrons, even though the dividends continued to be deductible by the cooperatives, this intent has not been carried out.

The President recommended that the law be amended to make the intent of the 1951 legislation effective. Another recommendation would extend the proposed tax withholding on dividends and interest to patronage dividends. Withholding on patronage dividends at the 20-percent rate would assure the average patron of the funds with which to meet his tax on noncash dividends.

The House bill provides an adequate remedy for the unintended exemption of some cooperative income. Under the bill, cooperatives would be permitted a deduction for patronage dividends paid in cash and for noncash dividends paid in the form of written notices of allocation. These written notices of allocation, in the form of noncash of "scrip" dividends, would be deductible by the cooperative either if they are payable in cash within 90 days at the option of the patron or if the patron has consented in writing to include them in his income, or if the cooperative has adopted a bylaw requiring all patron members to pay tax on these written notices of allocation. As under present law, patrons would not have to pay tax on dividends received with respect to purchases of items for personal use.

Cooperatives engaged in furnishing electrical energy or providing telephone service in rural areas would not be subject to these provisions as these cooperatives are exempt from taxation or are in the process of qualifying for exemption. The enactment of the House bill will insure that the earnings of cooperatives will be taxed currently, either to the cooperative or to the patrons. This provision will yield $35 million per year in additional revenue.

2. TAXATION OF MUTUAL FIRE AND CASUALTY INSURANCE COMPANIES (SEC. 8)

The House bill, in line with the President's recommendation, is designed to achieve more equal treatment of stock and mutual fire and casualty insurance companies.

Since 1942, the mutual companies have been taxed only on their investment income, subject to a minimum tax of 1 percent on gross income from all sources. This formula disregards both underwriting gains and underwriting losses. On the other hand, the stock companies are fully taxed on all of their income, in the same manner as other corporations.

Under H.R. 10650 mutual fire and casualty companies, after generous provision for reserves for losses in a deferred income account, would be subject to tax at ordinary corporate rates on net underwriting and investment income. Amounts equal to 1 percent of claims paid plus one-quarter of underwriting gain may be deducted from currently taxable income and credited to a deferred income account. If the amount set aside in this account in any taxable year is not used to absorb losses in the following 5 years it will be added to taxable income in the sixth year, but only to the extent of the 1 percent of claims paid and one-half of the one-quarter of underwriting gain that remains. Thus one-eighth of underwriting gains may be permanently deferred from taxation and, in addition, taxation of a large portion of underwriting gains is deferred for 5 years.

The 5-year deferral provision is continuous in its effect; taxation of each succeeding year's underwriting gain is deferred for 5 years. Thus it is more than a mere transition to regular corporate taxation. If the growth trend of the mutual companies continues, each successive year's underwriting gains will exceed the gains of the fifth preceding year, so that current full taxation will never be achieved. In addition, permanent deferral of one-eighth of underwriting gains is a windfall for the most profitable companies; only those companies with consistent underwriting profits will be able to enjoy this permanent deferral and the larger their profits the greater the value of the benefit.

The House provisions represent an important step toward placing the mutual fire and casualty insurance companies on a tax basis which recognizes underwriting as well as investment sources of income or loss. But the regular corporate basis of taxation, as originally recommended by the President, and as now applied to the stock companies, would provide simpler and more equitable treatment. In effect, this recommendation would eliminate both the 5-year and permanent deferral provisions of the House bill. Consideration, however, might be given to providing a gradual transition to regular corporate taxation over a 5-year period. This would be preferable to the continuing and permanent deferral provisions of the House bill.

Full corporate taxation would yield about $50 million of additional revenue annually. The provisions in the House bill will yield about $40 million after the lapse of 5 years.

3. MUTUAL SAVINGS BANKS AND SAVINGS AND LOAN ASSOCIATIONS

Under present law, mutual savings banks and savings and loan associations can deduct from their income amounts added to a reserve for bad debts until reserves, surplus, and undivided profits equal 12 percent of deposits or withdrawable accounts. As a result, during the entire decade, 1952–1961, all mutual savings banks and savings and loan associations paid total Federal income taxes of less than $70 million, while at the same time they retained $5.5 billion as additions to reserves, surplus, and undivided profits. From an economic and accounting point of view a large part of the untaxed additions to bad debt reserves constitutes net income which, were it earned by competing financial institutions, would be subject to corporate income tax.

H.R. 10650 goes part of the way toward implementing the President's recommendation that the tax laws should assure nondiscriminatory treatment of competing financial institutions. It reflects the conclusion of the House of Representatives that mutual thrift institutions do retain a considerable amount of income which should be subject to tax. The bill would substitute for the present reserve provision an annual deduction for reserves for bad debts of either 3 percent of the net increase in all real estate loans or 60 percent of the retained income of the institutions.

The proposed substitute reserve provision is still more generous than is warranted by any reasonable concept of a bad-debt reserve. The alternative deduction of 60 percent of the retained income of these organizations is not related to bad-debt reserve needs. In effect, it provides that the mutual thrift institutions will pay tax on about 55 percent of their operating income, computed after deduction of a reasonable reserve for bad debts and after distributions to depositors. In contrast the estimated comparable percentage for commercial banks is equal to about 80 percent.

I believe your committee will wish to reexamine this provision of H.R. 10650 in the light of the President's recommendations to assure nondiscriminatory taxation among competing financial institutions. The action by the House of Representatives will yield $200 million per year in revenue, contrasted with $365 million under a proposal that would provide taxation more closely comparable to that applicable to commercial banks. Such comparability could be achieved by alowing these insitutions to deduct from net income after distributions to depositors an amount equal to either 3 percent of net additions to real estate loans, as in the House bill, or 33⅓ percent of retained income before deduction of a reserve for bad debts. This alternative would permit tax-free additions to reserves of amounts well in excess of bad-debt reserve needs and would allow, in effect, substantial tax-free additions to capital. Under these alternatives the mutual thrift institutions would pay tax on about 80 percent of their net operating income, and thus this approach would achieve substantial equality in the taxation of competing financial institutions.

LOBBYING EXPENSES (SEC. 3)

Section 3 of the House bill would permit taxpayers engaged in business to deduct certain lobbying expenditures. These include the cost of appearing before committees of Federal State, or local legislative bodies, contacting individual legislators, transmitting legislative information between a taxpayer and an organization of which he is a member, and the portion of the dues paid by a member attributable to carrying on of such activities by the organization. The Treasury is opposed to this substantial change in the law.

THE TAXATION OF FOREIGN INCOME AND INVESTMENT

The President's recommendations on the tax treatment of foreign income and investment all support the general principles of equity and neutrality in the taxation of U.S. citizens at home and abroad, and as such would promote fairness and the efficient allocation of resources here and abroad. Moreover, since the special tax preferences we seek to eliminate tend to favor foreign over home investment, the President's recommendations have two important additional advantages for us at the present time. They will promote domestic capital formation and employment, and thus stimulate economic growth in this country. They will thereby reinforce the stimulating effect of the investment credit, which is limited to domestic investment. Implementation of these recommendations will also contribute to an improved balance-of-payments position for at least the next 10 to 15 years, when we expect we will most need that improvement. These considerations lend urgency to the enactment of the recommendations.

H.R. 10650 contains provisions relating to all of the President's recommendations, each of which I will take up in turn. In addition, I will deal with the growing problem of artificial tax incentives to short-term capital movements. The bill includes several technical provisions which I will only mention here, such as those dealing with gains from the liquidation of foreign corporations, distributions in kind, rules for allocating income on sales between U.S. parent corporations and their foreign subsidiaries, and reporting requirements with respect to foreign corporations. Under the House bill gain from the sale or liquidation of a stock interest in a controlled foreign corporation is taxed as ordinary income to the extent of the stockholder's share of earnings accumulated abroad, since 1913. The committee may want to consider whether it wishes to retain the applicability of this provision to earnings heretofore accumulated.

1. EXEMPTION OF EARNED INCOME OF INDIVIDUALS LIVING ABROAD (SEC. 12)

Under existing law an American citizen who qualifies as a foreign resident is tax exempt on all of his income earned outside the United States. A citizen who does not establish foreign residence but remains abroad for a period of 17 out of 18 consecutive months is exempt on earned income of up to $20,000 a year.

H.R. 10650 would continue the $20,000 annual exemption for those physically present abroad for 17 out of 18 months but would limit the exemption to $20,000 a year for our citizens who have been resident abroad for 3 or less years, and to $35,000 a year for those who

have been residents of foreign countries for more than 3 consecutive years.

There are about 50,000 U.S. citizens living abroad who claim an aggregate exemption of more than $500 million under these two provisions. The President recommended elimination of the exemption privilege for American citizens living in economically developed countries, since neither living conditions in such countries nor national policy requires special tax benefits in these cases. Because it is in our national interest, however, that Americans skilled in industry, education, medicine, and other professions be encouraged to go to less developed countries and contribute to their economic growth, the President also recommended continuing the exemption for our citizens who qualify as foreign residents of these less developed countries or who are present there for 17 out of 18 consecutive months, but only to the extent of $20,000 a year.

The limitations in the bill of $20,000 and $35,000 are generous in view of the allowance of the foreign tax credit and the fact that income that is exempt from tax is income that would otherwise be subject to higher statutory marginal rates than the remaining taxable income. For instance, an American citizen living abroad and earning a salary of $50,000 would pay no U.S. tax whatever on that salary under $20,000 exclusion if the foreign tax rate is as low as 19 percent, and under the $35,000 exclusion he would pay no U.S. tax if the foreign tax rate is as low as 7 percent. Equity, revenue needs, and balance-of-payments considerations all warrant modifying this section of H.R. 10650 to accord with the President's recommendation.

The bill's provisions on this matter will yield only $5 million per year in tax revenue, compared with $25 million under the President's proposal.

2. ESTATE TAX EXEMPTION OF FOREIGN REAL ESTATE (SEC. 18)

At present, foreign real estate is exempt from the U.S. estate tax. A number of persons have made investments in such property to take advantage of this exemption—in one known case, for the specific purpose of avoiding estate tax, $13 million was invested in this way within 6 months of death, with an estimated tax saving of $5 million. Under legislation adopted in 1951, a tax credit is allowed for estate and inheritance taxes paid abroad, and there is therefore no longer any possible justification for continuing the special exemption for foreign real estate. The amendment included in H.R. 10650 would correct this defect in the law and would involve renegotiating only one estate tax treaty, that with Greece. The effective date of the House amendment is July 1, 1964, but it would seem appropriate to change this to January 1, 1963. This provision would add $10 to $15 million per year to our tax receipts.

3. SHARES IN FOREIGN INVESTMENT COMPANIES (SEC. 15)

Unlike regulated domestic investment companies, foreign investment companies whose shares are held by persons resident in the United States are not subject to U.S. tax on income currently earned, unless that income is from U.S. sources. Hence, these companies

provide a means for shareholders in this country to accumulate investment income indefinitely without paying American taxes at either the corporate or shareholder level. Moreover, when a shareholder receives his pro rata share of such accumulated earnings by submitting shares to the company for redemption or by selling the shares, he obtains capital gains treatment on the income.

H.R. 10650, following the President's recommendation that this escape from ordinary taxation be ended, will eliminate the preferential treatment of income from foreign investment companies. Gain on the sale of shares in such companies, to the extent of the shareholder's undistributed portion of the company's earnings, would be taxed as ordinary income. An exception is allowed if the company elects to distribute 90 percent of its ordinary income annually and if, in addition, the shareholders report their portion of the company's realized capital gains, whether or not they are distributed.

It was not possible to estimate the revenue gain from this particular change. There are currently 13 of such companies, most of them Canadian, registered with the Securities and Exchange Commission, having total assets of $422 million. In addition, there are apparently many more companies not so registered.

4. FOREIGN TRUSTS (SEC. 9)

Under present law many American citizens are accumulating income in foreign trusts. The accumulated income is subject to little or no foreign tax. When the trust is finally terminated after a number of years, the corpus and income are brought back home to American beneficiaries who, in turn, pay little, if any, U.S. tax on the distribution. The House bill taxes the American beneficiaries on termination of the trust substantially as if they had received the trust income as it was earned. The bill therefore ends an unjustifiable device through which Americans are now able to accumulate income abroad solely for the purpose of escaping the U.S. income tax. While this provision of the bill will undoubtedly increase our revenues, it is again not possible to make any valid estimate.

5. "GROSSING UP" DISTRIBUTIONS IN COMPUTING FOREIGN TAX CREDIT ON DIVIDENDS FROM FOREIGN SUBSIDIARY CORPORATIONS (SEC. 11)

The income of an American-owned foreign subsidiary corporation is now subject to U.S. tax only when dividends are remitted to the parent company. The U.S. tax is computed as 52 percent of the actual dividend paid to the parent company less a tax credit approximately equal to the effective foreign tax on this dividend. The foreign income tax is, in effect, deducted from taxable profits in computing the U.S. tax, but a good share of it is also allowed as a credit against the U.S. tax liability. The combined effective foreign and U.S. tax rate under this method of computation can be reduced, depending on the foreign tax rate, to about 45 percent, or even 40 percent in cases involving two levels of foreign subsidiaries.

The following table illustrates this point:

TABLE 2.—*The computation of corporate taxes on foreign income*

	Existing law	Proposed law
	Dollars	*Dollars*
Profits of subsidiary	100.00	100
Foreign tax (assumed rate: 30 percent)	30.00	30
Divided to U.S. parent	70.00	70
"Gross-up" of dividend	....	30
Tentative U.S. tax at 52 percent	36.40	52
Credit for foreign tax paid by subsidiary	21.00	30
Net U.S. tax	15.40	22
Combined foreign and U.S. tax	45.40	52

To eliminate this unjustified tax advantage, H.R. 10650 contains an amendment that would require the U.S. taxpayer, as a condition for obtaining the foreign tax credit, to include in reported taxable income the full profit before the payment of foreign tax.

This results in a combined effective U.S. and foreign tax rate of 52 percent, where the foreign rate is not above the U.S. rate. This amendment will add $30 million per year to tax receipts.

The House bill postpones the effective date of this provision in two ways. It will not apply to pre-1963 earnings of foreign subsidiaries distributed as dividends before 1965, and it will not apply to distributions of current earnings prior to January 1, 1963. There is no reason to postpone the application of the grossup provision, especially since this change has been under consideration by Congress since 1959. I therefore urge that this change be made applicable to all distributions after December 31, 1961.

6. TAX-HAVEN TRANSACTIONS (SEC. 13)

Certain countries of the world, among them Switzerland, Panama, and various Western Hemisphere dependencies such as the Bahamas, do not tax at all, or tax at very low rates, corporate earnings attributable to activities carried on outside their borders. This situation, together with the privilege of deferring U.S. tax on retained earnings of foreign subsidiaries of American corporations, has invited the establishment of what may be termed "tax haven" corporations. Profits on oversea operations may be channeled into these tax havens as they are earned and taxes on these profits reduced to a level far below that applicable in the United States. The typical activities of such corporations include the handling, as middleman, of many trade transactions—transactions which often are largely paper transactions so far as the tax-haven corporation is concerned. They also include the sale of management services, the collection of licensing and other royalty payments, the insurance and reinsurance of U.S. risks, and the like. In addition, dividends and interest may be paid to these tax-haven companies from foreign subsidiaries in other countries, in a way that involves large savings in taxes.

The existence of these tax-haven operations constitutes a most serious breach in our principle of tax neutrality, one which is growing in quantitative terms by leaps and bounds every year. We are dealing here with a tax differential on retained income, not of 5 or 10 percentage points, but of 40 to 50 percentage points.

H.R. 10650 contains reasonably strong provisions with respect to tax-haven corporations, subjecting their trading earnings and income from dividends, interest, rents, and royalties to U.S. tax except where they are reinvested in less-developed countries. Receipts from insurance against U.S. risks, and from licensing of patents, copyrights, and so forth, which have been developed in the United States, are subject to tax without any exception for reinvestment. These tax-haven provisions, with technical refinement to clarify their application and to include certain tax-haven service income, will achieve a substantial improvement in equity and contribute as well to the solution of our balance-of-payments problem. They will also bring in an additional $75 million per year of revenue.

I would like to suggest only one major change in this section of the bill. While it is desirable to promote investment in less-developed countries, it is not necessary to do so by providing an artificial stimulus to investment in advanced industrial countries. The exemption of tax-haven profits invested in less-developed countries should be limited to earnings generated in the less-developed countries themselves. This change would add $25 million to annual revenues, increasing the receipts from this provision to $100 million.

7. GENERAL ELIMINATION OF DEFERRAL IN THE TAXATION OF FOREIGN SUBSIDIARIES (SEC 13)

H.R. 10650, as passed by the House of Representatives, apart from tax havens, deals only peripherally with tax deferral for foreign income, another important tax preference now accorded foreign, as compared with domestic, corporate income. It responds to the President's recommendation in this area only insofar as it specifies that the undistributed foreign income of U.S. subsidiaries operating abroad will be subject to U.S. tax as it is earned unless it is reinvested in substantially the same trade or business already conducted by the firm in question, or in a less-developed country.

By not treating the tax deferral issue fully and directly, the bill still retains a substantial tax advantage for investment abroad rather than at home. The privilege of deferring U.S. taxes until income is repatriated as dividends should simply be eliminated for our subsidiaries in advanced industrial countries, as the President has requested. The deferral privilege should be retained, for income earned in less developed countries, in line with our general foreign policy objectives.

To the extent that the U.S. tax exceeds the foreign tax liability, tax deferral provides at least an interest-free loan to American corporations which operate through a foreign subsidiary—a loan equal to the U.S. tax due on earnings retained abroad—and at most permanent forgiveness of a tax domestic corporations must pay.

Tax deferral thus serves as a special tax stimulus for American capital to go abroad and to stay abroad. No useful purpose or American interest is served when this artificial diversion is to highly developed countries. The efficient allocation of our own and world resources is upset. A drain is imposed on our already adverse balance of payments and the reduced domestic investment limits employment opportunities and retards our economic growth.

Let me turn first to the effect on employment. Artificial stimulation of American investment in developed countries makes it more difficult to maintain a high level of employment at home. The evidence relating to foreign investment in manufacturing as a whole indicates that an American dollar invested in Europe today generates a continuing annual flow of about 10 cents worth of U.S. exports of capital equipment, raw materials, intermediate goods, and finished products sold to and through oversea subsidiaries. That same dollar also generates each year, however, about 6 cents of U.S. imports from foreign subsidiaries. Moreover, the "net export" factor of 4 cents per dollar invested does not allow for sales made abroad by the foreign subsidiaries which displace actual or potential sales that would otherwise be made directly from the United States. If only a little over 1 percent of the more than $9 billion of sales by American-owned subsidiaries of the goods which they produce in Europe serves to displace sales from U.S. markets, or if 8 percent of estimated sales by these subsidiaries made outside the country in which they are located displaces sales from U.S. sources, the net export impact on the United States of foreign investment in Europe would be effectively offset.

Comparison of the precise immediate and long-range employment effects of investment of American capital in Europe and investment in the United States depends upon how much of our capital goods exports to American subsidiaries in Europe is assumed to be new equipment and how much is assumed to be for replacement purposes. The most favorable measure of the immediate employment effect in the United States of a dollar invested in Europe, on the basis of recent data, would be that it generates 10 cents worth of capital equipment exports from the United States, that is, that a dollar invested in Europe has an immediate effect on employment equivalent to 10 cents invested here at home. But under these assumptions, this dollar invested in Europe then generates only 3 cents worth of continuing net exports of raw materials and intermediate products, whereas the dollar invested at home would generate 40 cents worth of continuing production, assuming in both cases that demand is sufficient to absorb the increased output.

We find a very different picture in the relationship between U.S. investment and continuing export and import balances with respect to manufacturing subsidiaries in Latin America and other less developed regions. A dollar invested in these regions generates about 40 cents worth of net U.S. exports annually. The nature of manufacturing investment in these regions is radically different from that in advanced industrial countries. This difference explains why data for the world as a whole differ from those for developed countries only.

The artificial stimulation of U.S. investment in developed countries is harmful to our balance-of-payments position. Returning to my analysis, we find that each dollar thus invested contributes substantially to our balance-of-payments deficit. It has been argued, however, that this is the case only in the short run. Sooner or later, it is claimed, this outflow will result in compensating inflows in the form of dividends, fees, and royalties, in addition to inflows from continuing net exports. But in every year since 1953 the new capital outflow to Canada and Western Europe exceeded the new increases in inflows associated with the capital outflow in these years. It is clear

that the catching-up period will take at least 10 to 15 years, and much longer if capital outflow keeps growing. Obviously our current and foreseeable balance-of-payments needs will not permit a continuing drain on our resources for so long a period.

The various factors, data, and limitations involved in this analysis of the balance of payments impacts of foreign investment are fully discussed in the accompanying exhibit III. I wish to emphasize the importance of this exhibit for it clearly demonstrates two things: First, that the immediate balance of payments drain of new investment in the industrialized countries is not made up for at least 10 to 15 years. Second, that such investment stimulates little in the way of net new exports and so is of little help in creating jobs in the United States.

Looking ahead, we can see that elimination of tax deferral in developed countries would have two types of effects on our balance of payments. First, there would be smaller net outflows, because of a somewhat smaller growth in foreign investment each year, as a consequence of the elimination of the tax inducement to send capital abroad. The second effect on the balance of payments from the elimination of deferral arises from the fact that there would no longer be a tax inducement to leave earnings abroad.

In the hearings before the House Ways and Means Committee in the spring of 1961, the question of the effect of removing deferral was illustrated over and over again by reference to the experience of individual companies. Typically the new capital outflow reported as coming from the United States, usually year by year over some period of time, was compared with dividend income and with receipts from exports sold to or through foreign subsidiaries. "Inflows" so computed generally exceeded "outflows" by a substantial amount. This left the impression that the stimulus given foreign investment by tax deferral clearly contributes both to our employment situation because of the large export sales generated, and to our balance of payments position because total inflows exceeded outflows. There are five things wrong with this type of evidence.

First, the behavior of one company, or even a selected group of companies, may not be typical; net inflows of one may be more than offset by net outflows of others.

Second, the data on capital outflow as reported by individual companies often include only purchases of stock in foreign subsidiaries; but a very large amount of the new capital outflow to Europe and Canada as reported in Commerce Department data consists of net increases in intercompany accounts, for example, short-term credits for working capital which are not repaid.

Third, even if all the measurable inflows and outflows are correctly included in such data (and many company studies ignore sales by subsidiaries made directly to the United States—an important payment which may be an important offset to export receipts) one important flow is inevitably excluded because it cannot be readily measured—that is, foreign subsidiary sales abroad which displace actual or potential U.S. exports.

Fourth, the illustrations are almost invariably on a world-wide basis, whereas the Treasury proposal affects only income earned in developed countries. But as we have seen, there is a remarkable dif-

ference between the value of exports generated by a dollar of investment in advanced industrial countries and the value of exports generated by a dollar of investment in less developed countries.

These four limitations to the approach which has been typically employed to support tax deferral are serious enough, but it is a fifth limitation which is crucial.

The two types of flows being compared—the outflow of new capital and the dividend and export receipts for a given year or period—are not related one to another. The dividends, and most of the export receipts, of one year or period, have been generated by investment over many years prior to the current year or period; that portion of the inflows which has been generated by past investment, then, should not be considered when we are evaluating the employment and balance of payments effects of current outflows.

To return to our recommendations, we are concerned only with artificial tax inducements to investment abroad. We do not wish to impede such investment beyond removing these special preferences. Those who urge the continuation of these tax inducements must bear a high burden of proof that investment so induced contributes to employment at home, to an improvement in our balance-of-payments position, or to efficiency in the allocation of the world's resources. I submit that in the light of our analysis this argument simply cannot be sustained, even if one assumes a wide margin of error in our data.

It has also been argued that achieving tax neutrality between investment at home and abroad will unfairly affect the competitive position of U.S. subsidiaries vis-a-vis foreign firms, especially in the third-country markets. But let me here point out that most European countries impose direct controls on foreign investment—something we do not wish to do here—and that these controls adversely affect the position of corporations competing with American foreign subsidiaries. Insofar as taxation is concerned, our foreign subsidiaries at most would feel the effect of elimination of the deferral privilege only through a reduction in retained earnings. If this portion of the retained earnings is needed in the business, the parent can pay the U.S. tax or supply the additional needed capital in other ways. This situation is still preferable to that facing, for example, a British company, which must seek permission from the British Treasury to invest more abroad. The extent of the controls exerted in the United Kingdom today is illustrated by the following quotations from a statement delivered in Parliament last July by the Chancellor of the Exchequer:

> I now come to private investment overseas. The volume of investment in the nonsterling area which is subject to control has been rising steadily. It is true that it produces earnings in the long run. But these earnings do not always benefit the balance of payments in the short term—partly because of the tendency to invest further in the oversea enterprise concerned and partly because of local restrictions on remittances.
>
> I therefore propose a more severe test than at present. The test for new investment in the nonsterling area will be that it will produce clear and commensurate benefits to U.K. export earnings and to the balance of payments.

It is our understanding that this test may be considered satisfied if the investment is covered by dividends and/or increased exports within 2 years, a test under which few investments would appear to qualify.

With respect to the remittance of oversea profits, the Chancellor stated:

The powers to control investment in the nonsterling area apply equally to investment made out of profits earned overseas by British companies and their subsidiaries. I am not satisfied that in all cases an adequate proportion of profits earned overseas is being repatriated to this country. I propose to request U.K. firms operating overseas to look at their policies in order to insure that a higher proportion of earnings is remitted home. So far as nonsterling investment is concerned, I propose to reinstitute on a selective basis the examination of company accounts by the exchange control authorities to insure that this policy is followed.

I simply fail to see how anyone can logically claim that our tax proposals are either unfair or restrictive, when compared with this sort of treatment.

The question we must ask ourselves is whether or not it is in the national interest to provide a special subsidy, through tax preferences, for the growth of foreign subsidiaries in industrialized countries. I feel that the answer is clear—elimination of the special privilege of tax deferral is an appropriate change from the standpoints of letting the free market allocate resources efficiently, of assuring tax neutrality between operations here and in other highly industrialized countries, of stimulating growth and employment in the United States, and of supporting our essential balance-of-payments needs in the critical years ahead. Complete elimination of deferral with respect to corporate subsidiaries in the advanced countries should add a further $130 million to our tax receipts, over and above the $10 million that would result from the House bill.

8. ELIMINATING ARTIFICIAL TAX INCENTIVES TO CAPITAL MOVEMENTS ARISING OUT OF FOREIGN TAX CREDIT COMPUTATION

Last summer Canada revised its tax laws to provide a 57½-percent effective rate of Canadian tax applicable to income going to United States corporations operating in branch or subsidiary form in Canada. This Canadian tax rate in excess of the U.S. 52-percent rate has highlighted the operation of the existing method for computing the foreign tax credit as an artificial inducement to the outflow of short-term U.S. capital. This is harmful to our monetary stability and to our balance-of-payments position.

Under existing rules, a U.S. company deriving income from business abroad through a branch or a subsidiary may have an unused foreign tax credit where the foreign rate of tax on the income exceeds the U.S. rate. If, however, additional foreign-source investment income can be generated which is subjected to a foreign tax rate lower than the U.S. rate, the two kinds of income can be lumped together under the existing foreign tax credit rules. In this way the U.S. tax on the income from such investment funds can be completely eliminated by the excess credit from the tax on the business income of the company.

For example, the 57½-percent effective rate of Canadian tax applicable to income going to U.S. corporations operating in branch or subsidiary form in Canada leaves an excess credit of 5½ percent over the U.S. 52-percent rate. The Canadian rate of tax on interest income flowing to such corporations is only 15 percent. Consequently, some of these U.S. corporations have transferred to Canada short-

term funds, such as bank deposits, which ordinarily would be held in the United States. Since the excess credit from the business income will eliminate the U.S. tax on the interest income, the effect is to leave that income taxable at only a 15-percent Canadian rate, as compared with the 52-percent U.S. rate that would apply if the funds were held in the United States. Thus the existence of this situation serves as an artificial inducement to the movement of U.S. capital abroad.

In my report to the President on the balance of payments, transmitted to the Congress on March 28, 1962, I recommended that this situation be corrected. I suggest that the foreign tax credit for certain investment income be computed apart from the foreign tax credit for all other foreign income. In this way a foreign tax credit will be allowed against investment income only for the actual foreign taxes paid on such income. This will result in the same tax rate being paid with respect to short-term investment income of U.S. companies whether it is earned at home or abroad. We believe that this is an effective and fair way to correct this tax-induced disruptive monetary situation. A more detailed explanation of this recommendation and the proposed statutory language is submitted as exhibit III E.

9. TREATIES (SEC. 21)

The House bill provides that section 7852 (d) of the code shall not apply with respect to any amendment made by the bill. The effect is that the statutory amendments would supersede inconsistent existing treaty provisions. The Treasury believes that no part of the bill is contrary to any existing tax treaty, with the single exception that the elimination of the exclusion of foreign real estate from the estate tax runs counter to the 1950 estate tax convention with Greece. None of our income-tax treaties are affected by any section of the bill. Prior to the time when the foreign real estate provision becomes fully operative, we intend to renegotiate the treaty with Greece.

Some persons, however, have raised arguments, which we are confident are legally unsound, that certain other provisions of the bill conflict with some income-tax treaties. The Ways and Means Committee inserted section 21 to forestall useless litigation. We have no doubts about the outcome of such litigation and since section 21 may give the impression that we are overriding our treaty obligations, it would be desirable to dispel that impression. In that light, therefore, I recommend the elimination of section 21 to make it clear that we are honoring our treaty obligations.

REPEAL OF THE DIVIDEND CREDIT AND EXCLUSION

In 1961 and again this year the President has recommended repeal of the provisions enacted in 1954 which permit individuals to exclude from their taxable income the first $50 of dividends and to take a credit against tax of 4 percent of dividends in excess of this amount.

In 1959 and again in 1960 the Senate voted to repeal the 4 percent credit, but this action was not accepted by the conference committees. H.R. 10650, as passed by the House of Representatives, contains no provision on this important subject.

The dividend credit and exclusion were adopted in the light of current high rates of the individual income tax law on the ground

that they would provide a partial offset to the "double taxation" of dividends and encourage investment in corporate equities. Despite their large cost in revenue, however, they have failed to accomplish their objectives.

To the extent that double taxation of dividends exists, these provisions grant relief in a discriminatory fashion. They give the most relief to dividend recipients with high incomes and relatively little or no relief to dividend recipients with small incomes. The percentage reduction of the so-called double tax is about 8 percent for low income taxable stockholders, while it is about 40 percent for high income stockholders. This is illustrated in exhibit IV.

The present dividend provisions represent a dead-end approach toward the equitable taxation of dividends. In 1954 they were represented as only a first step for the relief of "double taxation," eventually to be made more complete by raising the credit to 15 percent of dividends. It is not feasible, however, to increase the credit to this level without giving those in the high tax brackets reductions exceeding the extra burdens they are presumed to bear as a result of the corporate income tax.

In the 8 years since the adoption of the dividend credit and exclusion the proportion of total corporate public long-term financing accounted for by stock issues has not been significantly higher than it was in the 8 years prior to 1955. The evidence does not support the contention that these provisions of the tax law have encouraged investment in, or the issue of, corporate equities.

We recognize that an argument can be made in favor of postponing action on this item until it can be considered in connection with overall tax reform. This in effect was the position taken by the Ways and Means Committee. However, we feel that the case on the merits is clear and do not see why this matter should be postponed. Therefore we recommend that the dividend credit and exclusion be repealed as of July 1, 1962. The resulting annual revenue gain would amount to $475 million.

SUMMATION AND REVIEW

H.R. 10650, as you have it before you, is a good piece of tax legislation. It will provide a much needed stimulus to the growth of the American economy, help substantially to alleviate our balance of payments problem, and achieve important gains in the area of tax fairness and neutrality. But as I have pointed out, we feel that there are certain improvements that can and should be made.

The following are my principal recommendations for changes in the bill. The investment credit should be restored to an 8 percent level and it should not be extended to regulated public utilities, including gas pipelines. Depreciation with respect to all real estate hereafter acquired should be limited to an amount not in excess of the depreciation allowed under the straight-line method. Gain on the sale of all real estate should be treated as ordinary income to the extent of depreciation for taxable years beginning after December 31, 1961, subject to a sliding scale cutoff for property held more than 6 years. The provisions dealing with entertainment and travel expenses should be strengthened in the manner I have suggested. Provisions for taxation of mutual banks and savings and loan associations should also

be strengthened in order to achieve substantial equality in the taxation of competing financial institutions. The deferral now permitted under the bill to mutual fire and casualty companies should be eliminated, with the result that these companies would be taxed on the same manner as stock companies. Tax fairness, revenue requirements, and our balance of payments position all demand that the tax deferral privilege now enjoyed by controlled foreign corporations in industrialized countries be eliminated. The provision in the bill which permits the deduction of certain lobbying expenses should also be eliminated. Finally, the dividend credit and exclusion have proved ineffectual in meeting the objectives they were designed to serve and should be repealed.

Table 3 presents the revenue effects of the bill, for a full year when all of the changes are fully effective, but without taking into account the effects on the economy of its various provision.

TABLE 3.—*Estimated revenue effect of H.R. 10650, when changes are fully effective, without any consideration of its stimulative effects on the economy* [1]

[Millions of dollars]

	As passed by the House	With Treasury proposed changes
Investment tax credit	−1,175	−1,350
Capital gains on depreciable property	+100	[2] +180
Withholding on dividends and interest	+650	+650
Expense accounts	+125	+250
Mutual banks and savings and loan associations	+200	+365
Mutual fire and casualty companies	+40	+50
Cooperatives	+35	+35
Foreign items:		
Controlled foreign corporations	+85	+230
Gross-up of dividends	+30	+30
All other foreign items	+30	+50
Repeal of the dividend credit and exclusion		+475
Total	+120	+965

[1] At levels of income and investment estimated for the calendar year 1962, except for mutual thrift institutions, for which the revenue gain is based on income estimated for calendar year 1963.

[2] Including effect of restricting depreciation deductions for real property to straight-line method.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Apr. 2, 1962.

The revenue effects are presented both with and without the effects of the changes proposed by the Treasury. You will note that for the full year the bill is more than balanced. As passed by the House it will yield a revenue surplus for the year of $120 million. With the Treasury's proposed changes this revenue surplus rises to $965 million.

In examining the revenue effects of the bill for the fiscal year 1963, it is necessary to follow the procedure employed in developing revenue estimates for the budget and take into account the impact of the investment credit and other features of the bill on investment, income profits, employment, and other factors affecting tax bases and revenues. This approach is essential for fiscal 1963 because the revenue consequences of the bill must be coordinated with budget estimates. On this basis, table 4 indicates that, as passed by the House, H.R. 10650 will reduce budget receipts by $320 million for fiscal year 1963, while incorporating the Treasury's proposed changes will yield a revenue gain of $90 million.

TABLE 4.—*Estimated net revenue effect of H.R. 10650 for fiscal year 1963, after taking partial account of its stimulative effects on the economy*

[Millions of dollars]

	Recommended effective date	As passed by the House	With Treasury proposed changes
Investment tax credit	Jan. 1, 1962	−560	−465
Capital gains on depreciable property	do		+5
Withholding on dividends and interest	Jan. 1, 1963	+195	+195
Expense accounts	July 1, 1962	+40	+80
Mutual banks and savings and loan associations	Jan. 1, 1963		
Mutual fire and casualty companies	do		
Cooperatives	do		
Foreign items:			
Controlled foreign corporations	do		
Gross-up of dividends	Jan. 1, 1962 [1]		+30
All other foreign items	Various	+5	+5
Repeal of the dividend credit and exclusion	July 1, 1962		+240
Total (see note)		−320	+90

[1] The effective date of the bill is Jan. 1, 1963.

NOTE.—In estimating the net revenue cost of the investment credit, its favorable effects on the level of investment were computed from statistical relationships in past years between investment and gradual changes in the cost of capital goods (profitability) and cash flow. This procedure thus does not take into account the especially favorable impact on businessmen's decisions to invest of the sudden major improvements in these factors resulting from the enactment of the credit. Taking this into account should produce more favorable effects and a larger surplus than the small net revenue gain shown in the table.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Apr. 2, 1962.

The figures presented in the table, however, take only partial account of the stimulative effects of the investment credit. They ignore the especially favorable impact on businessmen's decision to invest of the sudden major improvements in the cost of capital goods, or profitability of investment, and cash flow that will result from the enactment of the credit and are based, instead, on relationship in past years between gradual changes in these factors and investment. With proper consideration given to this fact, it is clear that the bill as it stands is approximately in balance and that with the Treasury's proposals added we can confidently expect a larger surplus than the small net revenue gain shown in the table.

The provisions of this bill should be regarded as the first major step in the tax reform program envisaged by the President when he delivered his tax message of 1961. The second step will be presented in the tax reform message which he is planning to send to the Congress later this year. By the time the second step comes before you for your consideration the revenue gain we expect the present bill to produce in a full year may provide some of the leverage that, together with the broadening of the tax base, will be needed to permit a substantial readjustment of income tax rates.

In view of the importance of the investment credit it is desirable that this bill be enacted as soon as possible. To accomplish this end I hope that you will concentrate your efforts on the subjects recommended by the President without the injection of new issues at this time. While there are many changes in the tax system that warrant consideration, they can better be treated in connection with the next step in the program.

Thank you, Mr. Chairman.

(The exhibits referred to follows:)

EXHIBIT I

THE INVESTMENT CREDIT

A. Greater Efficiency of the Credit as an Investment Stimulus, Compared with Alternatives

Table 1 - Profitability of Investment and Gross Revenue Cost Under the Investment Credit, Including Partial Credit to Utilities and Alternative Investment Incentive Programs

Table 1 presents a summary analysis of the effects of the investment credit, compared with alternative proposals on the rate of return (after tax) on a typical investment in a 15-year asset. It also shows the associated revenue loss in the first full year and over the first 5 years which would result from each of these alternative approaches.

This comparison shows that the investment credit would be superior to any of the alternatives as a means of increasing profitability of investment for the revenue loss involved. (A detailed explanation of the calculations underlying these profitability estimates appears in the Appendix to Table 1, A Detailed Explanation of the Method of Estimating Profitability of Investments).

As the analysis demonstrates, an 8 percent investment credit would increase the rate of return on a 15-year investment earning 5 percent after tax under present law with straight-line depreciation or 5.6 percent with double-declining balance depreciation to 7.3 percent. A 17 percent initial allowance which would involve somewhat greater revenue losses would increase the rate of return to only 6.1 percent or by less than one-third as much. To produce a stimulative effect on profitability equivalent to that of the 8 percent credit by means of an initial allowance approach, it would be necessary to provide a 40 percent initial write off. Such a 40 percent initial allowance would reduce revenues by some 2-1/2 to 3 times as much as the credit.

Compared with accelerated depreciation formulas which would operate by increasing annual depreciation by a prescribed percentage, an 8 percent credit would be more than 3 times as potent in stimulative effect as a 20 percent speed-up in depreciation which would cost nearly half as much revenue over the first 5 years. As the table shows, it is equivalent to a 90 percent speed-up in depreciation which would cost nearly twice as much revenue over the first 5 years.

As shown in Table 1, an 8 percent credit increases profitability on a 15-year asset by almost as much as 5-year amortization, which would cost more than 2-1/2 times as much revenue. For shorter-lived assets, the credit would have still greater effect in increasing the rate of return, while 5-year amortization would have less effect.

A comparison between an 8 percent credit and triple-declining balance depreciation indicates that the credit would increase the rate of return nearly 2-1/2 times as much as the triple-declining balance formula which would cost over 50 percent more revenue in the first 5 years.

The 7 percent credit proposal would involve a reduction in benefits by one-eighth or 12.5 percent on a given investment. The effect of the credit on rate of return on assets would be reduced proportionately. However, even at the reduced 7 percent rate, the investment credit is vastly superior in its effects on profitability to incentive depreciation proposals costing the same amount of revenue.

Table 2 - Rate of Return on Investments with Different Economic Lives Under the Proposed Investment Credit

This table shows the comparative impact of both 7 and 8 percent credits on rates of investment return for assets with different lives, ranging from 4 to 20 years. This analysis indicates that the credits would have greatest stimulative effect in the 6- to 15-year asset life range which comprises a major segment of productive machinery and equipment.

Table 3 - Present Discounted Value of Future Tax Deductions

This table provides a systematic analysis of the present discounted value of future tax deductions and benefits under the 7 and 8 percent credits and various depreciation formulas. These calculations are made for assets of different lives and assume a $1,000 investment, a 5 percent rate of discount, and a 52 percent tax rate.

This table affords a basis for evaluating the actual benefit of accelerated depreciation proposals as compared with the investment credit. The figures show, for example, that the present discounted value of double-declining balance depreciation on a 15-year asset is $408.58 and would be increased to $453.15 with a 40 percent initial allowance. Thus, a 40 percent initial allowance on a 15-year asset would increase the present discounted value of depreciation deductions under the double-declining balance method by $44.57 ($453.15 - $408.58). This particular benefit is slightly more than half the $80 present value of an 8 percent investment credit.

B. Need for the Investment Credit

Table 1 - Machinery and Equipment Gross Capital Formation as a Percentage of Gross National Product

Table 1 presents a summary comparison of machinery and equipment gross capital formation as a percentage of gross national product for

the United States, selected leading industrial countries, and the combined average for the European members of the Organization for Economic Cooperation and Development (O.E.C.D.), annually, for the period 1950-1960.

These data show that the machinery and equipment ratio for the U. S. was in general substantially lower than that of the various countries shown. In 1960, for example, the U. S. ratio was 40 percent lower than that of the United Kingdom, 55 percent lower than that of Germany, and 44 percent lower than that of the combined average of the European members of the O.E.C.D. This confirms a finding by the Machinery and Allied Products Institute based on similar O.E.C.D. data that in terms of its productive equipment ratio, the United States is apparently at the bottom of the list of leading industrialized countries. Moreover, the U. S. ratio trended downward during the 1950-60 period while the ratio for the European members of the O.E.C.D. increased by almost one-fourth.

Table 2 - Average Annual Increase in Gross National Product at Constant Prices, Selected Industrialized Countries, 1950-60

This table discloses the fact that for the 1950-60 period as a whole the average rate of economic growth of the United States, measured in terms of changes of GNP in constant dollars, was lower than that of any other of the leading industrial countries, with the exception of the United Kingdom.

Comparison of the ranking of the countries in terms of growth rate shown in Table 2 with the ranking with respect to the machinery and equipment ratio shown in Table 1, indicates a significant direct correlation between growth and investment in machinery and equipment.

Table 3 - Gross National Product and Business Expenditures for New Plant and Equipment, 1951-61

This table compares changes in GNP and business plant and equipment expenditures in the U. S. in current dollars for the period 1951-61.

During the period, GNP increased by $192 billion or 60 percent while business plant and equipment outlays increased by roughly $9 billion or 35 percent. Moreover, during the latter half of the period, while GNP rose about one-fourth, plant and equipment outlays receded. From a high of $37 billion in 1957 these business capital expenditures decreased to $34.5 billion in 1961, a decline of 7 percent. This divergence between GNP trends and plant and equipment outlays may be further understated to the extent that

equipment prices have risen more than the average prices entering into the measurement of GNP (GNP deflator). The growth in business plant and equipment expenditures has lagged behind the general U. S. growth rate, which in turn has been relatively low as compared with that of most other countries.

Table 4 - Estimated Age of Gross Stocks of Business Equipment

This table, based on data compiled by the Machinery and Allied Products Institute, shows a creeping rise in the average age of our business equipment since 1955. It also shows a striking increase in the proportion of equipment over 10 years old from about one-fourth in 1954 to more than one-third in 1959.

An aging stock of productive facilities, such as that shown in this table, is not characteristic of an economy which is increasing its efficiency through formation of new equipment in proportion to its general growth.

C. Reasons for the Exclusion of Public Utilities from the Investment Credit

This exhibit contains both a summary of the reasons why it would be inappropriate to grant the credit on investment by the regulated public utilities and a detailed discussion of the pertinent considerations, with supporting evidence.

EXHIBIT I-A

Table 1

Profitability of Investment and Gross Revenue Cost Under the Investment Credit, Including Partial Credit to Utilities, and Alternative Investment Incentive Programs

Proposal	Rate of return on assets with 15-year lives 1/	Gross revenue cost 2/ First full year	Gross revenue cost 2/ First five years
		(billions of dollars)	
Present law, depreciation taken under			
Straight-line method	5.0	--	--
Double-declining balance method	5.6	--	--
Proposed investment credit, depreciation taken under double-declining balance method 3/			
8 percent credit 4/	7.3	1.8	9.9
7 percent credit 4/	(7.1)	(1.2)	(6.6)
Incentive depreciation proposals			
Initial allowances, with double-declining balance depreciation			
40 percent initial allowance	7.3	5.3	24.1
17 percent initial allowance 5/	6.1	2.2	10.2
Acceleration of depreciation otherwise allowed under double-declining balance methods:			
90 percent increase in annual depreciation 6/	7.3	1.3	19.0
20 percent increase in annual depreciation 7/	6.1	.3	4.2
Five-year amortization	7.5	4.5	26.1
Triple-declining balance depreciation 8/	6.3	1.5	15.5

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See next page for footnotes.

Footnotes:

1/Rate of return is calculated on the assumption that gross revenues decline with the length of time that the machine is in place. A 50 percent tax rate is used. Alternative assumptions yield similar results.

2/Revenue cost is based on the assumption that about half of the new assets are depreciated under straight-line and half under declining balance methods. The cost is gross as recoupment of revenues from increased tax yields is disregarded. Allowances are made for loss corporations.

The gross cost assumes a 5 percent annual growth in investment for all measures. A more realistic calculation would prorate growth according to the impact that such proposal has on profitability.

3/Similar computations with alternative depreciation methods indicate that the credit increases rate of return by an approximately constant number of percentage points.

4/Revenue estimates for alternative proposed 7 and 8 percent credits take account of accompanying variations in the treatment of public utilities and in the statutory limitations on the amount of the credit applicable to the current tax liability.

5/The purpose of comparing the rate of return under a 17 percent initial allowance with the 8 percent investment credit is to provide a comparison in which the present value of gross revenue cost under both investment incentive plans is equal over the first five years. The net revenue cost of the 8 percent investment credit will be smaller than the net revenue cost for the 17 percent initial allowance because the credit stimulates more investment and recoupment; however, gross revenue cost of the 17 percent initial allowance will be smaller than the gross cost for the credit if present value of cost over a period longer than five years is considered.

6/The 13.3 percent depreciation allowed in the first year under present methods is increased to 25.2 percent. Depreciation in the second year is increased from 11.6 percent to 22.0 percent, and so forth, until 100 percent of the investment has been depreciated.

7/The cost cumulates to $15.2 billion after ten years, compared to $18.9 billion for the 8 percent investment credit.

8/As the profitability effect of this method hinges on the shift to new depreciation methods, it is assumed that all new investment is depreciated under triple-declining balance for purpose of the revenue estimates. Any investment not depreciated under triple-declining balance would reduce cost but would simultaneously eliminate the increase in rate of return associated with the new method.

APPENDIX TO TABLE 1
EXHIBIT I-A

A DETAILED EXPLANATION OF THE METHOD OF ESTIMATING PROFITABILITY OF INVESTMENTS

Principles Underlying the Profitability Calculations

The profitability, or rate of return, of an investment is calculated in the same manner as the yield on a bond. The buyer of the bond (or investment) (1) projects the return obtained after tax, year-by-year, and (2) finds that rate of discount which reduces future returns to the price of the bond (or asset). That rate is the yield, profitability, or rate of return of the bond. To give a simple example, a 20-year 4 percent bond, selling at $771, has a rate of return of 6 percent (before taxes). The $40 in interest received annually for 20 years plus the return of $1,000 in the twentieth year exactly equal $771 when they are discounted 6 percent per year, compounded. To calculate rate of return after taxes involves the same computation except that the income from interest coupons must be reduced by the amount of income tax payable, and the terminal repayment of $1,000 by the capital gains tax assessable.

The investor in equipment cannot foresee revenues with the same accuracy as the bondholder. Nevertheless his rate of return is based on the identical, albeit more uncertain, calculation. A manufacturer investing $1,000 in an asset expected to last 4 years and yield $300 cash return net of taxes in each year of operation, would obtain a 7.7 percent rate of return. The computation is illustrated in the table below:

Year	Cash return (after tax)	Present value of the cash return discounted at 7.7 percent
1	$ 300	$ 278.56
2	300	258.63
3	300	240.12
4	300	222.96
Total	$1,200	$1,000.27

If an 8 percent investment credit is granted to the investor in this example, his cash return at the end of the first year is increased to $380. The rate of return over the 4-year life rises to 11.1 percent as shown in the table below. The increase in profitability from 7.7 to 11.1 percent (approximately 44 percent increase) measures the incentive effect of the investment credit.

Year	Cash return (after tax)	Present value of the cash return discounted at 11.1 percent
1	$ 380	$ 342.04
2	300	243.06
3	300	218.79
4	300	196.92
Total	$1,200	$1,000.82

This calculation method was followed in the Treasury calculations of profitability. Revenues after taxes were obtained by making three assumptions: (1) the applicable tax rate is 50 percent, (2) the rate of return after taxes obtained under present law and straight-line depreciation methods is 5 percent, and (3) the amount of revenue that an investment yields tapers off, so that net revenues in later years are smaller than net revenues in early years. The declining net revenue assumption is based on the idea that maintenance costs rise with the age of the asset and demand for its product may decline with the passage of time.

Explanation of Increase in Profitability Associated with the Investment Credit

(1) Under straight-line depreciation a $1,000 10-year investment must produce $1,242 (cash after tax) in order to yield a rate of return of 5 percent. That is, if each year's cash flow is discounted by 5 percent interest, compounded annually from the date of investment, the total present discounted value of the cash returned by the investment equals $1,000.

(2) A switch to double-declining balance depreciation raises the rate of return from 5.0 to 5.6, as taxes are reduced in early years and the investment yields a higher proportion of its cash return in those years of its life. A comparison of cash flow available with both methods of depreciation is shown in the table below.

Year	Net revenues after taxes		Revenue under double-declining balance less revenue under straight-line depreciation	
	Straight-line depreciation	Double-declining balance depreciation	Year-by-year	Cumulative difference
1	184	$ 234	+50	+50
2	171	202	+31	+81
3	158	172	+14	+95
4	145	146	+ 1	+96
5	131	122	- 9	+87
---	---	---	---	---
10	63	46	-17	+17
Total	1,242	1,242	0	.0

(3) The 8 percent investment credit increases rate of return from 5.6 to 7.9 percent by increasing the cash return of the asset during its first year of operation by $80, that is, from $234 to $314. That is, the total cash return from the asset is increased to $1,322, and the rate of discount which will make the present value of $314 in year 1, $202 in year 2, etc., equal to the price paid for the asset, $1,000, is 7.9 percent.

(4) A 7 percent credit would only increase the first year's cash return by $70. It therefore produces only 7/8 of the increase in profitability associated with the 8 percent credit. (7/8 of the 2.3 increase associated with the 8 percent credit is 2.0. Profitability under the 7 percent credit therefore rises from 5.6 to 7.6 percent.)

The Relationship Between Profitability and the Cost of Funds

The increase in profitability of investment associated with the investment credit may be regarded as equivalent to a reduction in the financing costs of new investment. In other words the increase in profitability has the same effect on the firm's ability to finance new investment as a reduction in the rate of interest. The argument follows:

(1) It is assumed that assets are debt financed under a level payment plan whereby the principal and interest are repaid over the life of the asset.

(2) For a $1,000 15-year investment the annual payment of interest and amortization is $96.34 if the interest rate is 5 percent. If an 8 percent investment credit is available, the net cost of the asset is $920 and the associated payment is 92 percent of $96.34 or $88.63.

(3) If the interest rate drops to 4 percent, the level payment on a 15-year investment of $1,000 becomes $89.94, while if the interest rate is 3-1/2 percent the payment is $86.83. The $88.63 cost of financing the $920 at 5 percent clearly lies between the cost of financing the full investment of $1,000 at 3-1/2 percent and the cost at 4 percent. Interpolating between these amounts yields a 3-2/3 interest rate which is the interest rate that achieves the same reduction in financing cost as the 8 percent credit.

(4) For a $1,000 10-year asset the financing cost at 5 percent interest is $129.50. 92 percent of that amount is $119.14, the financing cost when the 8 percent credit is available. The financing costs of $1,000 at 3-1/2 percent are $120.20 per year; at 3 percent the financing costs are $117.20. We conclude that for 10-year assets the financing cost, when money is at 5 percent and the 8 percent credit is available, is equivalent to the financing cost without a credit when money is at 3-1/3 percent.

Table 2

Rate of Return on Investments with Different Economic Lives Under the Proposed Investment Credit

	Rate of return after tax on assets with lives of:				
	4 years	6 years	10 years	15 years	20 years
Present law					
straight-line depreciation	5.0	5.0	5.0	5.0	5.0
double-declining balance depreciation	5.7	5.6	5.6	5.6	5.5
Investment credit with double-declining balance depreciation					
8 percent proposal	7.2	7.8	7.9	7.3	6.9
7 percent proposal	(7.0)	(7.6)	(7.6)	(7.1)	(6.7)

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Table 3

Present Discounted Value of Future Tax Deductions
5 Percent Rate of Discount
$1,000 Asset, 52 Percent Tax Rate

	6 years	10 years	15 years	20 years
Depreciation methods presently allowed				
Straight-line depreciation	461.89	421.61	377.82	340.22
Double-declining balance depreciation 1/	480.12	446.14	408.58	376.33
Sum-of-the-years-digits depreciation	480.64	452.34	420.45	391.97
8 percent investment credit with				
a. Straight-line depreciation	514.89	501.61	457.82	420.22
b. Double-declining balance depreciation 1/	533.12	526.14	488.58	456.33
c. Sum-of-the-years-digits depreciation	533.64	532.34	500.45	471.97
7 percent investment credit with				
a. Straight-line depreciation	(508.89)	(491.61)	(447.82)	(410.22)
b. Double-declining balance depreciation 1/	(527.12)	(516.14)	(478.58)	(446.33)
c. Sum-of-the-years-digits depreciation	(527.64)	(522.34)	(490.45)	(461.97)
Incentive depreciation proposals				
Expensing in years of purchase	520.00	520.00	520.00	520.00
Five-year amortization	472.78	472.78	472.78	472.78
Initial allowances with double-declining balance depreciation 1/				
40 percent	496.05	475.67	453.15	433.88
17 percent	486.99	458.63	427.80	400.91
Acceleration of depreciation otherwise allowed under double-declining balance methods 1/				
20 percent increase in annual depreciation	492.91	465.39	434.38	406.70
90 percent increase in annual depreciation	510.02	495.50	477.10	459.73
Triple-declining balance depreciation	497.00	469.57	439.19	412.28

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1/ Computed with switch to straight-line method.

Note: Present discounted values are computed as of the end of the year in which the investment is made, using the compound discount formula $P = \frac{An}{(1+r)^n}$ (assuming a 5% rate of discount).

EXHIBIT I-B

Table 1

Machinery and Equipment Gross Capital Formation as a Percentage of Gross National Product

Year	European Members of the O.E.C.D. combined 1/	Canada	France	Germany	United Kingdom	United States
1950	8.0%	8.3%	7.4%	9.7%	7.0%	6.6%
1951	8.3	8.8	8.2	10.2	7.1	6.4
1952	8.2	8.4	7.7	10.5	6.8	6.1
1953	8.1	8.7	7.4	10.5	6.9	6.1
1954	8.4	7.9	7.4	11.2	7.2	5.7
1955	8.9	7.7	7.9	12.3	7.6	5.8
1956	9.1	9.0	8.3	12.1	7.7	6.5
1957	9.2	9.2	8.8	11.3	8.2	6.4
1958	9.1	7.7	8.6	11.3	8.3	5.2
1959	9.2	7.8	8.3	11.4	8.2	5.3
1960	9.8	7.6	8.4	12.1	9.1	5.5

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1/ Includes Belgium, Luxembourg, France, Germany (F.R.), Italy, Netherlands, Austria, Denmark, Greece, Iceland, Ireland, Norway, Portugal, Sweden, Switzerland, Turkey, United Kingdom. Excludes data for Spain.

Note: Investment includes productive equipment bought by governments and government enterprises, but excludes such equipment used for military purposes.

Source: O.E.E.C. Statistical Bulletin, July, 1961.

Table 2

Average annual increase in gross national product at constant prices, selected industrialized countries, 1950-60

Country	Percent
Japan	8.5% 1/
Germany	7.5
Austria	5.9
Italy	5.8
Netherlands	4.7
France	4.6
Switzerland	4.3 2/
Canada	3.7
Sweden	3.5
Belgium	3.1
United States	3.0
United Kingdom	2.6

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1/ 1953-60

2/ 1954-60

Source: Machinery and Allied Products Institute, Capital Goods Review, January, 1962, p. 1.

Table 3

Gross National Product and Business Expenditures for New Plant and Equipment 1951-61

(in current dollars)

	G.N.P.	Business expenditures for new plant and equipment
	(billions of dollars)	
1951	$329	$25.6
1952	347	26.5
1953	365	28.3
1954	363	26.8
1955	398	28.7
1956	419	35.1
1957	443	37.0
1958	445	30.5
1959	483	32.5
1960	504	35.7
1961	521	34.4

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Source: Economic Indicators, March, 1962.

Table 4

Estimated Age of Gross Stocks of Business Equipment 1/
1947-1959

	Average age	Percent over 10 yrs.
1947.....	9.5 yrs.	35.6%
1948.....	9.0	32.6
1949.....	8.8	30.9
1950.....	8.7	30.2
1951.....	8.6	30.2
1952.....	8.5	28.4
1953.....	8.5	26.5
1954.....	8.6	25.7
1955.....	8.5	25.9
1956.....	8.7	27.4
1957.....	8.8	29.8
1958.....	9.0	32.4
1959.....	9.0	33.4
1960.....	n.a.	n.a.
1961.....	n.a.	n.a.

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Source: Machinery and Allied Products Institute

1/ Includes agricultural equipment.
n.a. Not available.

EXHIBIT I-C

REASONS FOR THE EXCLUSION OF PUBLIC UTILITIES FROM THE INVESTMENT CREDIT

I. Public utilities are regulated monopoly industries with legal obligations to serve public convenience and necessity.

1. Investment in utilities thus is determined by public demand.

2. The rates utilities charge consumers for their services are determined in a manner that allows just and reasonable rates of return on investment. Cost of interest payments is considered an expense and return on equity is set sufficiently high to attract the capital required to serve public needs.

3. It is questionable whether the benefits of the credit, if extended to utilities, would be passed on to consumers in the form of lower service charges, to shareholders in the form of dividends, or retained. Whether or not the benefits are reflected in reduced service charges, the regulatory process would be gravely complicated by conflicting pressures, resulting in uncertainties and litigations which would hamper orderly rate adjustments.

II. Assuming the credit were granted to the utilities, and that the utilities themselves retained the benefits of the credit, available evidence indicates that the credit would not achieve its intended incentive to investment.

1. Regulated utilities do not need tax incentives to induce them to meet their service obligations to the public and would not increase their construction program in response to the investment credit in the same manner or to the same degree as other industries.

2. Current levels of high excess capacity now exist in the electric utility industry, suggesting that the investment credit will not stimulate desirable investment, if it stimulates any investment at all.

3. The gas pipelines share the characteristics of other regulated utilities. Moreover, the rapid expansion of the industry, and the necessity for certifying new investment combine to make the investment credit particularly inappropriate in their situation.

(R)

4. The lack of evidence in support of the need for capital in small utilities, coupled with the concentration of utilities' investments in firms with ready access to the capital market, does not support the need for the credit as a source of capital.

5. Recent unsatisfactory experience with accelerated amortization in the electric utility field, culminating in the refusal by Congress to issue further amortization certificates in 1957, is illustrative of problems involved in attempts to stimulate public utility investment.

III. Assuming the credit were granted to the utilities, but passed on to consumers, in lower service charges, there would be little benefit to the economy and an aggravation of present problems in rate-making procedures.

1. The pass-through of the credit to users would not produce significant decreases in utility rates. Federal Power Commission data indicate that a pass-through of the credit to consumers would decrease the average householders' electric bill by a mere 7 cents a month.

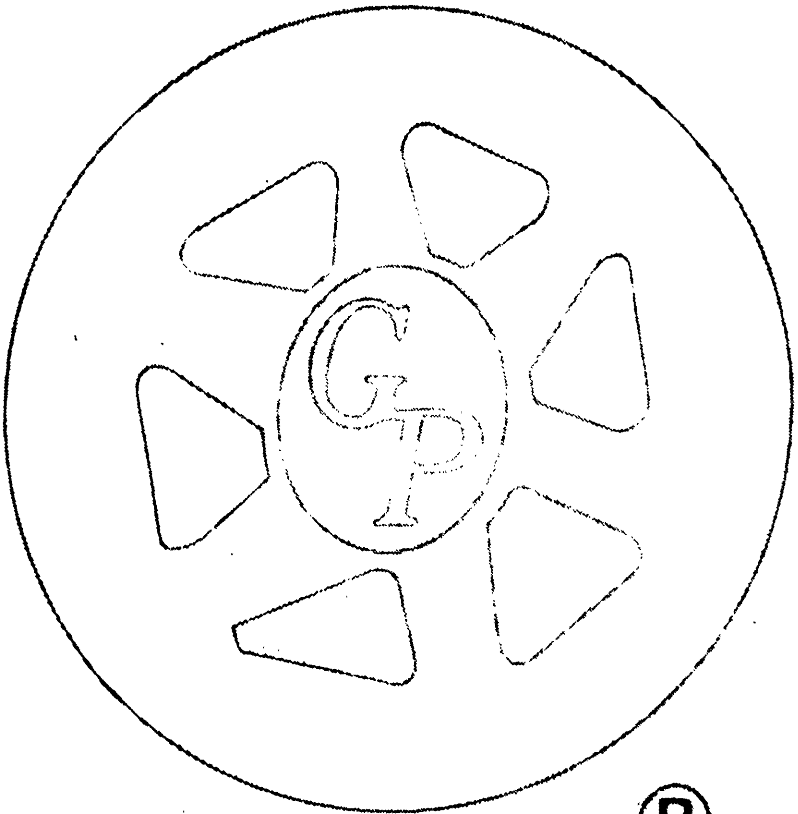
2. A reduction in rates of this magnitude would have an insignificant impact on the level of consumer and industrial demand.

3. Rate regulation agencies would be faced with an impossible task in monitoring rates to follow the fluctuating investment expenditures and accompanying investment credits for which utilities would be eligible.

IV. The primary goals of the investment credit would not be furthered by including utilities.

1. The investment credit is needed to encourage investment in firms requiring modernization of equipment in order to compete with foreign producers for markets here and abroad, to stimulate domestic stagnant economic conditions, and to strengthen the international competitive position of American industry. By their nature utilities produce for a domestic market and are not subject to foreign competition.

2. Granting the credit to utilities would cost $300 million under the 4 percent proposal and $225 million under the 3 percent proposal. Little productive use will be made of that amount, and the net cost to the government will be substantially higher than in manufacturing where competition will enforce productive use of funds.



DETAILED ARGUMENT FOR THE EXCLUSION OF PUBLIC UTILITIES FROM THE INVESTMENT CREDIT AND SUPPORTING DATA

1. Utilities' Investment Needs Are Determined By Public Demand

The public utilities are regulated monopoly industries which are legally obligated to serve public needs and which construct their facilities on a demand basis to meet public requirements. Studies of investment in both the telephone and electric power industries conclude that the relationship between present demand and capacity is the primary determinant of investment. Investment in utilities does not occur spontaneously to create new demand but is determined by demand. 1/

2. Utilities Are Regulated Monopolies Afforded the Opportunity to Earn Just and Reasonable Rates of Return After Tax

In return for their authorization to operate as regulated service corporations, they are assured consumer rate charges which will cover their costs of operation, including Federal income taxes, plus a just and reasonable rate of return on investment. This rate of return is set so as to attract the capital needed to serve the public convenience and necessity. 2/ For the vast majority of utilities the rate of return presently available, when adjusted for the lack of risk on that investment, equals or exceeds the rate of return in other industries. Furthermore, the rate of return is gauged to enable the utility to obtain adequate capital at whatever cost is required.

(See Appendix A to Exhibit I-C.)

Because the corporate income tax is treated as a cost of operation, the utilities and their investors do not bear the burden of the tax. They are therefore not subject to the disincentive effects which the tax may have on investment decisions of other industries not sheltered by regulated monopoly conditions. In addition, the risk of investment in the utility field is less than in industry generally. The utilities have no difficulty raising capital needed for expansion.

3. Utilities Will Not Raise Investment Significantly in Response to the Credit

With a captive monopoly market, guaranteed rates of return, ready access to capital funds, and need for new investment determined largely by long-range trends in consumer demand, public utilities are not likely to respond in the

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1/ See Avram Kisselgoff and Franco Modigliani: "Private investment in the electric power industry and the acceleration principle," Review of Economics and Statistics 39 (1957), pp. 363-379 and Paul G. Clark, "The telephone industry: a study in private investment," in Wassily Leontief, Studies in the structure of the American economy (New York: Oxford University Press 1953), pp. 243-94.

2/ Typically the firm's rates are individually regulated in such a way as to provide the full amount of revenue required to service its long-term debt and preferred stock, as well as a return on common stock which is "fair", as judged by price earning ratios and similar measures of the cost of equity capital.

same manner as other industrial corporations operating in competitive markets to tax incentives such as the investment credit.

Unlike manufacturers who can stimulate new markets by developing new products, the gas and electric utilities offer a commodity that has changed imperceptibly over the past half century. They cannot stimulate new types of demand that the manufacturing firm can tap with new products. Rather the utilities' new investment satisfies growing consumer needs that they are legally required to meet and that they can readily project for the years ahead.

4. Experience With Amortization Program in Regulated Industries Was Unsatisfactory

The unsatisfactory results of attempts to stimulate public utility investment are exemplified by the recent experience with accelerated amortization in the electric utility field. This experience was critically reviewed by the Congress when it restricted the further issuance of amortization certificates in 1957. Chairman Byrd of the Senate Finance Committee, in commenting on the matter in 1957, stated that he regarded such rapid tax write-offs for utilities as without any justification whatever because utilities are guaranteed profits. 1/

The report of the Senate Judiciary Committee made by its Subcommittee on Antitrust and Monopoly concerning the experience of regulated industries under rapid amortization stated:

> "Grave consequences have followed the enormous grants of tax amortization to operating utilities in the electric power field. Consumers have fared badly, for the Federal Power Commission rules that lower rates were not the purpose of the tax amortization statute, and the courts have sustained the FPC. As a result of the hearings, the Federal Power Commission surveyed operating utilities and it was established that to an unsuspected extent, tax-free dividends were being paid. Public power witnesses complained of predatory practices by utilities enjoying the lower net taxable income coming from high-depreciation charges, and the subcommittee obtained a listing of all acquisitions made by utilities subsequent to obtaining amortization." 2/

(See Appendix B to Exhibit I-C)

1/ U. S. Senate, Committee on Finance, Rapid Amortization of Emergency Facilities, Hearings before the Committee on Finance, Eighty-fifth Congress, First Session on S. 1795, May 7 and 9, 1957, p. 9.

2/ U. S. Senate, Committee on the Judiciary, Subcommittee on Antitrust and Monopoly, Rapid Amortization in Regulated Industries, Eighty-fifth Congress, Second Session, Senate Report No. 1380, March 12, 1958, p. 67.

5. Investment Credit Would Tend to Be Passed On to Consumers and In the Process Would Gravely Complicate Rate Regulation

The extension of the investment credit to the utilities would tend to bring heavy pressure on the various regulatory commissions to pass the benefit on to consumers in the form of lower rates. Assuming such a pass-through, there would be little, if any, incentive effect to utility investment. While some of the pass-through would serve to reduce costs slightly for industrial users, much of the benefits would affect residential consumption.

There is, however, serious doubt as to how the investment credit might be treated by the various regulatory agencies. While existing law would appear generally to call for the "flow-through" approach, it is possible that the credit might lead to pressures for some type of "tax normalization" approach which would permit the utilities to retain the credit in addition to their fair rate of return on investment. In any event, the credit would gravely complicate the regulatory process and become a continuing source of controversy and litigation.

In view of the conflicting pressures on the regulatory agencies, the treatment of the credit would probably not be uniform in all jurisdictions. Moreover, before the issues were resolved there would be a period of uncertainty and confusion which would not be favorable for investment or the orderly operation of the utilities. Granting the credit to utilities would introduce discriminatory treatment of different firms, as regulatory agencies responded with different procedures for passing the credit through to consumers.

Special difficulties would be involved in applying the flow-through principle to the credit because, unlike general tax reduction, the credit would vary from year to year with the capital expenditures of the utility corporation. This variance in the tax reduction from year to year would make it extremely difficult for the regulatory authority to determine the proper rate adjustments. Substantial tax credits would be likely to go neither to lower rates nor to additional investment, but into dividends to shareholders. The resulting erratic distribution of the credit in the regulated area and the numerous disputes it would engender would not serve the best interests of either the utilities industry or the Nation in the long run.

(See Appendix C to Exhibit I-C.)

6. Insignificant Effect of the Credit On Consumer Demand

Some utilities have contended that if the credit were passed on so as to lower the cost of service to consumers, this would increase demand and therefore provide a basis for additional investments in production facilities.

Estimates of the possible effect of passing on the entire amount of the benefit of a 3 percent credit in the form of lower utility rates suggest an average reduction of cost to electricity consumers of less than one percent. 1/ For the average residential customer whose electric bill was about $7.25 a month in 1959, the resulting reduction would amount to about 7 cents a month. Similarly, for industrial and commercial customers whose average electric bill in 1959 was $880 a year or about $73 a month, the adjustment would be about $.69 a month. These reductions are so small as to be an insignificant stimulus to the consumer in changing his use of electricity, even if the demand were reasonably elastic. While reliable estimates are not available on the elasticity or responsiveness of demand for electric power to price changes, there is reason to believe that it has a relatively low degree of elasticity. 2/

7. High Levels of Excess Capacity Now Exist in the Electric Utility Industry

The high levels of excess capacity which now exist in the case of the electric utilities suggest that the investment credit would not be effective and is not needed in this area.

The data on the growth of excess reserves of kilowatts stated as a percentage of December peak loads indicates that in the postwar period reserve capacity over the peak load reached a level of 19.3 percent in 1954, declined to 17.3 percent in 1956, but rose steadily since then to a high of 28.6 percent for 1960. 3/

(See Appendix D to Exhibit I-C.)

1/ The one percent figure is based on an estimate of $88.5 million credit which the electric power utilities would have received on their 1959 eligible investment in relation to $9.5 billion of operating revenues.

2/ Franklin Fisher and Carl Kaysen estimate that household demand for electricity is inelastic; sales would not respond to price declines sufficiently to maintain their revenues from households. Industrial demand tends to be somewhat more elastic, but on the average, one must conclude that over-all elasticity of demand in industry is probably close to unity, indicating only slight increases in gross revenues from industry with decreasing prices.

(See Appendix E to Exhibit I-C.)

Demand for gas is also inelastic. A.M. Strout estimates that elasticity of demand for all heating fuels is about three-tenths, indicating that a one percent decrease in price would stimulate three-tenths of a percent increase in quantity sold or a loss in revenues of approximately seven-tenths of one percent. (See A.M. Strout, "Weather and the demand for space heat" Review of economics and statistics, 43 (May, 1961) pp. 185-192.) Though greater substitution among fuels can be anticipated in the long-run and the long-run elasticity will be higher, competition between fuels is effectively limited by the high costs of conversion and one can expect little response from the consumer to a reduction in prices.

3/ Data from June, 1961, issue of FPC "Electric Power Statistics".

The 1956 report of the Joint Committee on Internal Revenue Taxation on the 5-year amortization program indicated that the Office of Defense Mobilization operated on the assumption that an excess capacity reserve in the neighborhood of 24 percent would be required for full mobilization in 1955, which is well above the actual reserves maintained during the Korean War. When reserve capacity reached 20 percent, the goal was closed, presumably because this level was deemed adequate. 1/

8. The Investment Credit is Especially Inappropriate for Gas Pipelines

The natural gas pipeline industry has expanded at a very rapid rate without the investment credit. As of the end of 1960, the index of plant investment was around 350, as compared to 100 at the end of 1950.

So far as is known, no desirable expansion or modernization has been prevented by lack of readily available funds.

Expansion of interstate natural gas pipelines can be effectuated only with a certificate of convenience and necessity issued by the FPC. The Commission requires an affirmative showing of the adequacy of reserves before any such certificate will be granted. Certification procedures are designed to assure orderly growth in the industry, and will limit the extent to which the investment credit can stimulate growth.

9. The Investment Credit as a Stimulus to Investment

The investment credit is required to provide the maximum stimulus to investment that will raise our rate of growth, increase productivity, and assist sectors of the economy where economic conditions have caused business to fall behind in its modernization of equipment. The utility industries are not in special need of such a stimulus.

1/ U. S. Congress, Joint Committee on Internal Revenue Taxation, "A Report on 5-year Amortization of Emergency Defense Facilities Under Section 168 of the Internal Revenue Code of 1954," December 1956, p. 25.

The investment credit specifically excludes buildings and residential construction, as investment in those areas contribute little to modernization of the Nation's industrial productivity. Excluding utilities is but another way in which the impact of the credit would remain focused on investment that will best strengthen our industrial efficiency.

10. <u>The Credit is Not Discriminatory to Public Utilities</u>

Exempting utilities from the credit is not discriminatory to the public utility industry. The legally intended incidence of the income tax paid by the public utilities is on their consumers. Consistent with this principle, the benefits would be passed to to consumers and the utilities would have no net gain from receiving the credit.

11. <u>Purpose of Strengthening International Competitive Position of American Industry is Primarily Applicable to Businesses Other Than Public Utilities</u>

The credit is intended to aid manufacturing and other industries in strengthening their ability to compete with foreign producers for markets here and abroad. This goal is largely inapplicable to utilities which are only indirectly concerned with problems of foreign competition. The need for the credit is clearly greatest in the case of manufacturing and other businesses which need to keep abreast of foreign competition that already receives special investment tax incentives.

12. <u>Industries Would Not Construct Their Own Utility Facilities to Obtain Advantage of the Credit</u>

The proportion of the total electric power generated by industrial firms has declined steadily since the late 1930's.

(See Appendix F to Exhibit I-G)

This suggests that the utility industry has been able to make increasing use of economies of scale in large generating plants. Increasing size of generating installations makes it uneconomic for most manufacturers to generate their own power. As the initial investment has an expected life of about 30 years, and most industrial plants would have a highly variable need for power over that period, it is highly unlikely that a shift to self-generating power by industrial corporations would be stimulated by the credit. 1/ In fact the current trend would appear to be in the opposite direction. Many companies now lease production machinery, vehicles, and special equipment, as well as buildings, in order to minimize the capital investment required and permit flexible changes in the product lines, method of production, and location.

1/ Profitability calculations indicate that the value of the credit is less on 30-year assets than on assets with a shorter life. Hence there is less incentive to the industrial producer here than in an investment in production machinery and equipment with a life of 15-years.

13. <u>Impact of the Credit On Small Utilities</u>

It has been contended that the investment credit would be a boon to small utilities that do not have ready access to the capital market and have a low rate of return. With the exception of a few firms that account for a very small part of the market, there does not appear to be any support for the contention that rates of return are lower in small utilities. In electric utilities, for example, many of the smaller companies with assets of $5 to $50 million enjoy a rate of return of 3.1 to 4.5 percent, a return substantially in excess of the 2.8 percent return enjoyed by the industry's largest firms. 1/

About four-fifths of the investment in utilities is concentrated in firms with over a quarter of a billion dollars in total assets that have ready access to the capital market and a rate of return that appears comparable to manufacturing when it is discounted for the lack of risk in utilities and the greater ratio of debt to equity financing. This implies that only a minuscule portion of the credit granted to utilities would go to smaller firms.

(See Appendix G to Exhibit I-C.)

14. <u>Revenue Consideration</u>

The extension of the credit at 3 percent to the public utilities would involve a revenue cost of $225 million at anticipated 1962 investment levels. This cost is considerably more than the cost of raising the proposed credit in other areas by a whole percentage point, a rise which can be expected to stimulate considerable quantities of new investment in manufacturing and elsewhere.

The investment credit would not only have a substantial initial cost in the utility industry, it would also be more expensive in the long run. Due to the fact that the credit is expected to stimulate less investment in the utility sector than in other industries, less growth in GNP and eventual recoupment of initial revenue losses can be expected from credits extended to the utility then can be expected from credits granted elsewhere.

15. <u>If the Credit is Not Passed On to Consumers, Windfall Benefits Acc[illegible] to Stockholders</u>

Utilities have had ready access to funds for financing new inv[illegible] during past years. They are much less likely than other industries to [illegible] backlog of investment projects which could not be financed if funds [illegible] not made available through the investment credit. For this reason the utilities are more likely than any other group to pay out the cose benefits

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1/ These rates are based on net income after taxes as reported on tax [illegible]. Book incomes will be somewhat higher, and will indicate a greater [illegible] return.

of the investment credit in the form of dividends. As a consequence much of the reduction in tax liabilities made possible by a credit to utilities will become an immediate benefit to the stockholder, rather than a stimulus to additional investment.

16. Competitive Position of the Utilities in Relation to Other Energy Suppliers Who Will Receive the Full Amount of the Credit

Even though the utilities do not receive the credit, there is little reason to believe that their sales will suffer as a result of competition from oil, coal, and other energy sources. Use of these other energy sources on existing equipment would require conversion of equipment that could only be undertaken at great expense.

Thus only new investment would be strongly affected by the price differential. In the case of electric utilities a large part of demand resulting from new investment is entirely independent of other fuels as there are not satisfactory substitutes for electric illumination, small electric motors, and electric power for chemical purifying and refining uses which account for a high proportion of the sales of electricity. In the case of natural gas, it is questionable whether the price differential arising from granting the credit to non-utility industries would give oil and coal a sufficient competitive edge to capture a greater share of new installations for heating, where the automatic delivery, cleanliness, and low maintenance costs of gas are important factors in the choice of heating fuels.

17. Conclusion

The available evidence indicates that the credit would not achieve its intended incentive to investment in the case of the regulated monopoly industries. The application of the credit would be inappropriate in the case of corporations enjoying sheltered markets and just and reasonable rates of return which in effect insulate them from the corporate income tax. Exclusion of utilities from the credit will not impair their right to realistic depreciation revision which may be found appropriate in the light of Treasury depreciation studies. Extension of the credit to utilities on the other hand would cost disproportionate amounts of revenue. As recognized by important sectors of the utility industry itself, the credit might be prejudicial to the best interests of the utilities in the long run.

Appendix A to Exhibit I-C

STATE COURT OPINIONS FAVORING PASS THROUGH OF TAX INCENTIVE BENEFITS

In holding that utilities should be required to pass on to their ratepayers the benefits of liberalized depreciation under Section 167 of the Internal Revenue Code, the Pennsylvania Superior Court said (City of Pittsburgh v. Pennsylvania P.U.C., 182 Pa. Superior Ct. 551, 125 A. 2d 372, 382-383):

> * * * Counsel asserts that, since utilities are an important segment of the national economy, they must likewise benefit. The weakness in this assertion is in failing to recognize the distinct nature of a utility as a regulated quasi-monopoly. As such it may obtain funds for modernization and expansion at the current reasonable cost, and it is allowed to pass this cost on to its customers in an annual depreciation allowance and its annual allowable net return as well. In fixing the rate of return the commission takes cognizance of the cost of capital to the utility. It appears therefore that this general desire of Congress to provide working capital and funds for modernization and expansion is, and has been for many years, adequately met for public utilities through rate proceedings. * * *

Similarly, the Supreme Court of Illinois, said (City of Alton v. Commerce Commission, 19 Ill. 2d 76, 165 N.E. 2d 513, 520-521):

> * * * Under the policy of this State, utilities are allowed a rate of return calculated to attract the capital required for necessary expansion. * * * Since in this respect utilities differ from other corporations, the purpose of section 167 would not be thwarted nor would discrimination be introduced into the Federal tax law by requiring utilities to pass the savings of accelerated depreciation on to their customers. * * * utilities are at least partial monopolies, and no competition exists to induce them to pass savings on to the public. * * *

Appendix B to Exhibit I-C

HISTORICAL PRECEDENT OF ACCELERATED AMORTIZATION

The FPC, in line with perhaps the majority of other regulatory bodies passing on the issue, permitted utilities to normalize income taxes paid with the benefit of accelerated amortization under Section 168 of the Internal Revenue Code. (The FPC and many state commissions have adopted the same procedure with respect to liberalized depreciation under Section 167.) Utilities thereby accumulated very substantial reserves. Yet the fact is, as set forth at some length in a report of the Subcommittee on Anti-trust and Monopoly of the Senate Judiciary Committee, that accelerated amortization had no real tendency to encourage construction of emergency facilities.

For example, the subcommittee said:

> " * * * Under the policies then [i.e., April, 1955] in force, no clear relation to defense needs was required for approval of certificates for electric power generation as they were granted on the basis of total demand, including civilian as well as military needs. The lack of incentive was indicated by the fact that <u>in the few instances where proposed facilities were held ineligible</u> -- because of location in target areas -- <u>the utility companies constructed them despite the rejection</u>. * * * [emphasis supplied.]"

The subcommittee further said:

> "Of the applications considered by the Department of the Interior and the Office of Defense Mobilization, approval was given to facilities scheduled to bring in 13,013,450 kilowatts. Applications which were denied because of their target area location totaled 5,298,000. All of the projects so denied still are scheduled for completion in 1958, despite the withholding of the tax-amortization inducement."

Appendix C to Exhibit I-C

"FLOW-THROUGH" OF THE CREDIT TO CONSUMERS AND ASSOCIATED COMPLICATIONS

The rate-regulating agency would have to monitor each utility's investment in every year to assure that the company did not earn an excessive return through the investment credit. The following table indicates the varying effect of the credit among companies during the period 1958-1960.

Estimated Effect of 3 Percent Tax Credit
Customer Benefit vs. Stockholder Benefit
Selected Utilities - 1958-9-60 Data

Company	Results Whether Customer or Stockholder Gets Benefits	
	Customer Benefit Pt. Year 1/	Stockholder Benefit Extra Return on Equity 2/
Consolidated Edison Company of New York		
1958	$ .83	1.04%
1959	1.11	1.33
1960	1.99	2.17
Northern States Power Company (Minn.)		
1958	$ .61	.66%
1959	1.18	1.13
1960	1.35	1.32
The Detroit Edison Company		
1958	$1.37	1.00%
1959	1.14	.84
1960	.45	.33
Pacific Gas & Electric Company		
1958	$1.36	1.20%
1959	.85	.78
1960	.81	.76
Appalachian Power Company		
1958	$2.88	2.78%
1959	.57	.55
1960	.57	.54

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1/ Average reduction in residential electric bills consequent to rate reductions on residential sales made possible by the investment credit.

2/ Average percentage point increase in rate of return to equity made possible by passing the investment credit through to stockholders.

Appendix D to Exhibit I-C

System Capacity and Peak Loads 1940 - 1960

United States Totals for Major Systems (Kilowatts)

End of Year	Dependable (Adverse Water Year)	December Peak Loads	Indicated Reserves (Excess of Depend. Over Dec. Peak Load As % of Peak)
1940	34,403,434	27,948,071	23.1%
1941	37,353,709	31,531,206	18.3
1942	39,665,335	32,942,464	20.4
1943	42,416,767	37,060,061	14.5
1944	43,760,322	37,853,847	15.6
1945	45,373,031	37,368,925	19.8
1946	45,701,894	43,173,803	5.9
1947	48,146,326	47,554,537	1.2
1948	52,689,808	51,611,873	2.1
1949	59,285,449	54,238,069	9.3
1950	65,574,230	61,719,096	6.2
1951	72,687,954	67,869,836	7.1
1952	80,035,407	73,055,403	9.6
1953	89,802,220	78,592,567	14.3
1954	102,055,254	85,580,848	19.3
1955	114,512,107	98,291,077	16.5
1956	120,453,230	102,723,432	17.3
1957	128,325,252	107,388,343	19.5
1958	141,827,422	113,679,341	24.8
1959	154,537,818	121,561,168	27.1
1960	165,536,249	128,713,483	28.6

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Source: June 1961 issue of FPC "Electric Power Statistics."

Appendix E to Exhibit I-C

ELASTICITY OF ELECTRIC DEMAND

Household Demand

Long-run household demand is influenced primarily by the acquisition of electric appliances. A recent statistical study concludes 1/:

"In summary, these long-run results indicate that the growth of the stock of appliances is insensitive to the price of electricity within the range of experienced prices. Whether much larger differences in the prices of appliances than those previously observed would make a difference in the rate of growth of the appliance stock is not clear from these data, nor are these regressions a really adequate explanation of appliance ownership as such. They do suffice to indicate the effect of electricity price, however, which is all that is at issue here."

Industrial Demand

Long-run industrial demand is shaped by changing technology as well as the price of electricity. The same study concludes:

"The results are generally significant and correlations are quite high. The upper limit to price elasticity is somewhat greater than unity in six out of the ten industries (highest 2.6, for the chemicals industry), unity or less in two more and zero in the remaining two (fabricated metal products and transportation equipment). Similar results are obtained for the mineral industries. Altogether, there is reason to expect a fairly high degree of sensitivity to electricity price in industrial demand given the technology of 1956. The paucity of the data makes it fairly difficult to be certain, however, and the effects of technological change are certainly more important than in the price effect just discussed."

1/ Fisher, Franklin M. and Kaysen, Carl, A Study in Econometrics: The Demand For Electricity In the United States, Amsterdam: North-Holland Publishing Co. (1962) 5-7.

Appendix F to Exhibit I-C

Generating Capacity
Privately Owned Electric Utilities and Industrial
Establishments, 1939-1960

(thousand kw)

Year	Combined Capacity	Privately Owned Utilities Capacity	Industrial Establishments	
			Capacity	Percent of Combined Capacity
1939	44,483	33,908	10,575	24%
1940	45,433	34,398	11,035	24
1941	47,631	36,041	11,590	24
1942	49,626	37,442	12,184	25
1943	51,717	39,128	12,589	24
1944	52,610	39,733	12,877	24
1945	53,064	40,307	12,757	24
1946	53,104	40,355	12,749	24
1947	54,816	41,987	12,829	23
1948	58,436	45,381	13,055	22
1949	63,954	50,484	13,470	21
1950	69,106	55,175	13,931	20
1951	74,544	60,192	14,352	19
1952	79,435	64,349	15,086	19
1953	87,053	71,201	15,852	18
1954	95,413	79,127	16,286	17
1955	103,311	86,887	16,424	16
1956	107,790	91,145	16,645	15
1957	114,474	97,376	17,098	15
1958	126,256	108,202	18,054	14
1959	136,510	118,999	17,511	13
1960	145,793	128,000	17,793	12

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Source - FPC

Appendix G to Exhibit I-C

THE INVESTMENT CREDIT AND SMALL UTILITY COMPANIES

It has been argued that the credit will provide aid to small utility companies that have difficulty financing new investment projects by issues of stock and bonds in the capital market. Clearly such companies are an infinitesmal portion of the industry. If future investment is roughly proportional to the present investment in utility companies corporations with assets in excess of a quarter of a billion dollars will receive four-fifths of the $225 million benefits that would be granted by a 3 percent credit.

The attached tables present the investment in utility companies, their rate of return, and the percent of total investment held by companies, by size of total assets. For purposes of comparison a similar tables has been prepared for all manufacturing corporations. The tables indicate:

(1) Investment is heavily concentrated in utility companies with more than a quarter of a billion dollars of assets. (See Table 1.) Firms of that size have ready access to the capital market and can attract equity or debt capital on favorable terms.

(2) The rate of return as reported by utilities of different sizes does not appear to vary systematically, 1/ while the rate of return in manufacturing increases with the size of the firm. (See Tables 2 and 3.) Thus while there may be some justification in special aid to small manufacturing corporations to help them raise their return, no such aid to the utilities would appear necessary or desirable.

The rate of return as reported by the telephone industry appears higher than that reported by the gas and electric utilities, but this is partially the result of the fact that 30 percent of the investment in gas and electric utilities is being depreciated under accelerated methods while only 1 percent of the investment in telephone and telegraph is being depreciated under these methods. Taking account of the reduced risk of investment in utilities and the typically high ratio of debt to equity capital, utilities' rates of return are roughly comparable to rates of return in manufacturing. Ratios of bonds with maturity of one or more years to total capital account are about 16 percent for manufacturing, 35 percent for communications, and 52 percent for gas and electric companies. If equity financing requires a yield approximately 1½ to 2 times that required for bonds, the difference in capital structure would account for most of the observed difference in rate of return.

1/ Variation in rate of return does occur as utilities are individually regulated in a way to reflect difference in the structure of their capital and the cost of capital which may vary according to market valuations of the firm's management, potential for growth, and so forth.

Table 1
Investment in Electric, Gas, and Telephone Utilities By Size of Firm
(1958-59)

Size of firm	Telephone Communications	Gas production and distribution 1/	Electric companies and systems
Under $100,000	.2	*	*
$100,000 less than 500,000	.8	.3	*
$500,000 less than 1.0 million	.7	.1	*
$10 million less than 2.5 million	.7	.5	.2
$2.5 million less than 5 million	.4	.6	.4
$5 million less than 10 million	.8	1.2	.2
$10 million less than 25 million	1.2	3.1	.9
$25 million less than 50 million	.8	4.4	1.4
$50 million less than 100 million	1.9	5.6	2.5
$100 million less than 250 million	.5	16.7	18.3
$250 million and over	92.0	67.5	76.1
Total percent	100.0	100.0	100.0
Total amount (in billions of dollars)	$24.0	$14.5	$40.8

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Source: Statistics of Income Data Sourcebook

*less than .05 percent

1/ excluding natural gas production

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EXHIBIT I-C
Table 2
Rate of Return and Investment in Public Utilities
As Measured By the Ratio of Net Profits After Taxes to
Total Assets Less Accumulated Depreciation and
Amortization By Size of Corporation
(tax year: 1958-1959)

Total assets of corporation	Telephone Communication		Gas production and distribution 1/		Electric companies and systems	
	Investment (millions)	Rate of return (percent)	Investment (millions)	Rate of return (percent)	Investment (millions)	Rate of return (percent)
Under $100,000	42.3	5.3	5.2	.9	3.3	3.0
$100,000 less than $500,000	190.9	2.9	37.8	1.7	16.7	13.9
$500,000 less than $1.0 million	158.2	2.9	15.9	.2	19.9	4.2
$1.0 million less than 2.5 million	180.0	2.1	65.6	4.0	68.2	6.9
$25 million less than 5 million	99.4	4.9	86.7	5.3	165.0	1.0
$5 million less than 10 million	203.3	4.1	171.2	3.7	88.4	4.5
$10 million less than 25 million	255.3	3.6	451.3	3.9	382.3	3.1
$25 million less than 50 million	202.7	4.0	633.4	3.7	553.1	3.8
$50 million less than 100 million	457.2	3.6	816.2	3.0	1,002.7	3.3
$100 million less than 250 million	120.4	8.8	2,424.7	1.7	7,467.7	2.8
$250 million and over	22,092.9	5.7	9,798.7	2.1	31,019.3	2.8
TOTAL	24,002.6	5.5	14,506.7	2.3	40,786.6	2.8

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1/ Excluding natural gas production

NOTE: The rate of return estimates are based on net income for tax purposes related to net total assets. These rates will be much smaller than book net income related to equity.

Source: Statistics of Income Data Sourcebook

Table 3
Investment and Rate of Return in Manufacturing as Measured
By the Ratio of Net Profits After Taxes to Total
Assets Less Accumulated Depreciation and Amortization
(tax year: 1958-1959)

Total assets of corporation (thousands)	Investment (millions)	Rate of return (percent)	Percent of total investment
Under 25	310	- 1/	.1
25 under 50	697	- 1/	.3
50 under 100	1,771	- 1/	.8
100 under 250	5,112	1.3	2.2
250 under 500	6,131	3.8	2.6
500 under 1,000	7,942	3.7	3.4
1,000 under 2,500	12,315	4.6	5.2
2,500 under 5,000	10,237	5.3	4.3
5,000 under 10,000	11,177	6.0	4.8
10,000 under 25,000	17,695	5.6	7.5
25,000 under 50,000	13,523	5.5	5.7
50,000 under 100,000	18,532	6.1	7.9
100,000 under 250,000	25,586	6.2	10.8
250,000 and over	104,808	5.5	44.4
TOTAL	235,836	5.5	100.0

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Source: Statistics of Income Data Sourcebook

1/ Losses reported in 1958-1959.
NOTE: The rate of return estimates are based on net income for tax purposes related to net total assets. These rates will be much smaller than book net income related to equity.

EXHIBIT II

WITHHOLDING ON DIVIDENDS AND INTEREST

Table 1 provides the estimated dividend gap for 1959.

Table 2 provides the estimated interest gap for 1959.

Table 3 shows the revenue effect of the gaps and the imposition of withholding.

Table 4 presents the results of IRS case studies of reporting of interest credited to bank accounts during 1958.

Table 5 presents the results of an IRS survey of reporting of interest on Series E savings bonds redeemed during 1951.

Tables 6 and 7 list selected fraud prosecution cases of substantial underreporting of dividends and interest in which convictions were secured during 1960 and 1961.

Tables 8 and 9 list examples of substantial underreporting uncovered by audit in the 1960 information document survey conducted by the IRS.

Table 10 presents a comparison of the relative costs and relative revenue gains from a withholding system, an ADP-enforcement system, and a withholding system supplemented by ADP and enforcement.

Chart A illustrates graphically the relative effectiveness of the three systems shown in Table 10.

Exhibit II-A presents excerpts from the January 25, 1962 speech by Commissioner Mortimer M. Caplin in which he discussed in detail the IRS conclusions after exhaustive study of withholding and ADP-enforcement as alternative systems for remedying the problem of nonreporting of dividends and interest.

WITHHOLDING ON DIVIDENDS AND INTEREST

Gap estimates

The dividend and interest underreporting gaps are estimated from aggregate figures of the amounts of such payments to individuals and of the amounts reported by individuals on their tax returns. This method has also been used by the New York Stock Exchange and independent tax experts whose estimates have corresponded closely with Treasury estimates.

1. Dividends (Table 1)

For dividends the estimate is based on cash distributions to stockholders by domestic corporations, as reported in the Internal Revenue Service Statistics of Income, and adjustments are made to add foreign dividends received by individuals, and to exclude dividend payments to corporations, tax-exempt organizations, and persons not required to file tax returns and to exclude distributions which are not taxable or are capital gains. The balance presumably should appear on individual tax returns if there were complete compliance in tax reporting. This type of calculation is shown in Table 1 for the year 1959. The 1959 underreporting gap was $940 million; the underreporting gap attributable to taxable individuals was estimated at $840 million.

2. Interest (Table 2)

The interest underreporting gap has at times been estimated starting from the Commerce Department's estimate of interest receipts by individuals, unincorporated businesses and nonprofit institutions. The Commerce Department's concept of personal interest income includes about $10 billion of imputed interest (largely interest assumed to be earned on bank deposits, which is not paid to individuals but is absorbed by the bank in lieu of service charges). The large adjustments involved in the Commerce Department concept cast a good deal of doubt upon such a gap estimate. In consequence, the Treasury has used a different approach namely, estimating directly amounts of interest payments to individuals and then deducting certain relatively small amounts of interest received by sole proprietors as business income, by individuals not required to file tax returns, and by tax-exempt organizations. This type of calculation for the year 1959 is shown in Table 2. The interest underreporting gap for 1959 was estimated at $2,780 million; the gap attributable to taxable individuals was $1,940 million.

Revenue effect (Table 3)

To estimate the revenue effect of dividend and interest underreporting, an adjustment is made to exclude the amount assumed to go to persons required to file tax returns but who would not be taxable even if they had reported properly. Table 3 shows these adjustments for dividends and interest for 1959. The table shows an estimated revenue gain of $850 million by complete elimination of interest and dividend nonreporting. The table also shows the estimated $470 million revenue gain from the application of the 20 percent withholding alone, and the estimated $650 million revenue gain if in addition to withholding there is an improvement in tax compliance by persons subject to individual income tax rates above the 20 percent bracket.

Case studies of reporting of bank deposit interest (Table 4)

The Internal Revenue Service undertook to study the reporting of interest credited to bank deposit accounts during 1958. A random sample of depositors was selected in eight banks in three New England States. The amount of interest paid or credited to each depositor's account was compared with the amount reported on the income tax return of the depositor.

The Service found that in more than half of the cases studied the depositor failed to report the deposit interest on his tax return (Table 4). In 5 percent of the cases, the depositor understated the amount of interest paid or credited.

In terms of amounts of interest, 38 percent of the interest recorded by the banks for the cases studied was not reported on tax returns.

Case studies of the reporting of Series E savings bond interest (Table 5)

During 1953 and 1954, the Service studied bond redemption cases to determine the extent to which those who redeemed Series E savings bonds in 1951 reported the interest on 1951 tax returns. The names and addresses of those who redeemed the bonds were noted and the amount of interest received. The income tax returns of these individuals were traced to determine whether the bond interest was reported.

In the case of a few taxpayers no returns could be located, probably largely because they were not required to file returns. For those whose returns were located, it was found that 86 percent failed to report any savings bond interest whatsoever (Table 5). In only 11 percent of the cases was the interest fully reported, and in 3 percent partially reported. In terms of amounts, 71 percent of the bond interest that should have showed up on tax returns went unreported and untaxed.

Selected cases of substantial nonreporting (Tables 6, 7, 8, and 9)

To provide explicit evidence of purposeful underreporting of interest and dividends, the Treasury selected recent fraud prosecution cases in which substantial amounts of such income were unreported. These are shown in Tables 6 and 7. All of the 34 cases summarized in Table 6 were prosecuted and resulted in convictions being secured during 1961. All of the 33 cases summarized in Table 7 were prosecuted and resulted in convictions being secured during 1960.

Tables 8 and 9 contain lists of examples of substantial underreporting which were uncovered in the 1960 information document surveys. All of the underreporting was confirmed on audit.

Automatic data processing is no substitute for withholding (Table 10 and Chart A)

The Internal Revenue Service has carefully studied the application of ADP and withholding to the problem of unreported dividend and interest income. It is the Service's conclusion that withholding would be much more effective and considerably less costly than an ADP-audit system. The latter could recapture at the most only $200 million in taxes at a cost of $27 million. In contrast, withholding will recapture $650 million in taxes annually at a cost to IRS of only $19 million. Table 10 and Chart A present the relative costs and relative gains of the two alternative systems. In addition the table and chart show the revenue gains and costs of a system of withholding supplemented by ADP and audit enforcement activity.

In Exhibit II A, the conclusions of the IRS are detailed in excerpts from a speech entitled "Automatic Data Processing and Withholding for Dividends and Interest" by Commissioner of Internal Revenue Mortimer M. Caplin delivered before the Section on Taxation, New York State Bar Association Annual Meeting, New York, January 25, 1962.

Table 1

Estimated dividend income of individuals not accounted for on tax returns for 1959

(In millions of dollars)

	1959
Cash distributions to stockholders by domestic corporations, Statistics of Income	16,160
Domestic dividends received by domestic corporations, Statistics of Income, less dividends received from Federal Reserve Banks	2,920
Net dividends paid by domestic corporations	13,240
Domestic dividends paid abroad	- 430
Foreign dividends received by individuals	+ 120
Distributions paid to individuals, fiduciaries and tax-exempt organizations	12,930
Distributions of small business corporations taxed as partnerships	- 160
Distributions exempt from tax	- 200
Distributions taxable as capital gains	- 510
Dividends received by corporate pension funds 1/	- 380
Dividends received by other tax-exempt organizations 1/	- 500
Dividends received by persons not required to file or who use 1040-A	- 120
Dividends retained by estates and trusts	- 400
Total deductions	-2,270
Dividends includable on individual tax returns	10,660
Dividends reported on individual tax returns	9,710
Dividend reporting gap	950
Attributable to non-taxable filers	110
Attributable to taxable filers	840

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NOTE: Figures are rounded and will not necessarily add to totals.

1/ Estimate limited to corporate pension funds as defined by SEC. Joint, union controlled and non-profit institution funds are included with other tax-exempt organizations.

Table 2

Estimated interest income of individuals not accounted for on tax returns for 1959

(In millions of dollars)

	1959
Interest payments to individuals:	
Cash interest paid on Government securities 1/	1,600
Interest paid on corporation bonds and notes 1/	850
Interest on time and savings deposits 1/	2,500
Interest on savings shares 1/	1,950
Interest paid on holdings of foreign bonds	70
Interest on farm mortgages paid to non-farm individuals	240
Interest paid on non-farm mortgages	1,320
Interest paid to unincorporated brokers and dealers	110
Interest paid to unincorporated consumer credit companies	160
Interest paid on life insurance dividends left to accumulate	90
Interest paid to retail auto dealers	50
Total payments	8,940
Deduct:	
Interest reported as business income by sole proprietors	470
Interest received by low income individuals not required to file	190
Interest receipts of non-profit organizations	300
Total deductions	960
Interest includable in individual tax returns	7,980
Interest reported as such on tax returns:	
Individuals - Form 1040	4,390
Individuals - Form 1040-A	20
Partnerships	330
Fiduciaries	470
Total	5,210
Estimated amount of interest payments not accounted for	2,780
Attributable to non-taxable filers	830
Attributable to taxable filers	1,940

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NOTE: Figures are rounded and will not necessarily add to totals.
1/ These items include payments to non-profit organizations.

Table 3

Revenue effect of withholding on dividends and interest under H. R. 10650 (1959 data)

(millions of dollars)

	Dividends	Interest	Total
A. Total estimated gap	950	2,780	3,730
To nontaxable filers	110	830	940
To taxable filers	840	1,940	2,790
B. Revenue gain from complete enforcement	350	500	850
C. Revenue gain from 20 percent withholding only	150	320	470
D. Estimated improvement in upper income brackets due to withholding	130	50	180
E. Revenue gain from withholding plus estimated improvement in upper income brackets (C) + (D)	280	370	650

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Table 4. Tax Compliance in Reporting Savings Account Interest in 1958 -- Sample Survey Based on Depositors in Mutual Savings Banks in New England

	Number	Percent of Total
Number of Cases		
Total in survey	1,279	100
With interest fully reported	539	42
With interest partially reported	69	5
With no interest reported	671	53
Amount of Interest on Savings Accounts		
Total in survey	$129,790	100
Reported on returns	80,644	62
Unreported on returns	49,146	38

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Table 5. Tax Compliance in Reporting E-Bond Interest by Taxpayers Who Redeemed Bonds in 1951 -- Sample Survey 1/

	Number (Thousands)	Percent of Total
Number of Individuals Redeeming Bonds		
Total number earning interest, where tax return was located for inspection	4,060	100
With interest fully reported	449	11
With interest partially reported	128	3
With no interest reported	3,483	86
Amount of Interest on E-Bonds (thousand dollars)		
Total paid out by Treasury, where tax return was located for inspection	$246,357	100
Reported on returns	71,930	29
Unreported on returns	174,427	71

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1/ The survey sample results have been "blown up" to represent all taxpayers who redeemed E-bonds in 1951.

Table 6 Selected Examples of Substantial Under-reporting of Dividends and/or Interest in 1961 Fraud Prosecution Cases 1/

Case No.	Dividends and/or Interest: Determined to be Reportable	Reported on Return	Under-reported	Tax year	Adjusted Gross Income Per Return	Occupation of Taxpayer
1.	$ 3,823	$ 3,462	$ 361	1954	$ 10,727	Bus Driver Schoolteacher
	5,303	3,995	1,308	1955	11,279	
	6,130	4,118	2,012	1956	10,631	
	6,969	4,163	2,806	1957	10,499	
	7,089	4,007	3,082	1958	8,646	
2.	1,284	-	1,284	1954	1,518	Insurance Agent and Farmer
	1,319	-	1,319	1955	2,639	
	1,403	-	1,403	1956	4,571	
	1,905	-	1,905	1957	4,986	
3.	567	80	487	1954	(521)	Attorney
	800	110	690	1955	528	
	1,233	148	1,085	1956	121	
4.	267	-	267	1957	5,838	Farmer and Dairy Operator
	2,149	-	2,149	1958	5,485	
5.	3,353	924	2,429	1955	10,451	Insurance Salesman
	4,562	1,556	3,006	1956	8,810	
	4,167	2,184	1,983	1957	7,375	
6.	6,109	250	5,859	1954	1,581	Truck Gardener
	5,778	-	5,778	1955	1,640	
	5,704	-	5,704	1956	1,604	
	5,387	-	5,387	1957	1,621	
7.	493	-	493	1954		Check Casher
	591	-	591	1955	No Ret.	
	728	-	728	1956		
	636	-	636	1957		
	901	-	901	1958		
8.	1,002	-	1,002	1954	4,025	Doctor
	985	-	985	1955	4,147	
	1,301	-	1,301	1956	(50)	
	1,473	908	565	1957	3,673	
9.	10,410	4,235	6,175	1953	4,403	Wholesale Merchant
	11,733	5,755	5,978	1954	558	
	13,336	11,977	1,358	1955	7,418	

1/ Convictions secured during 1961.

Case No.	Dividends and/or Interest: Determined to be Reportable	Reported on Return	Under-reported	Tax year	Adjusted Gross Income Per Return	Occupation of Taxpayer
10.	$ 95	$ -	$ 95	1956	$	Attorney and Tax Practitioner
	368	-	368	1957	No Ret.	
	346	-	346	1958		
11.	802	-	802	1955	7,951	Printer
	1,068	-	1,068	1956	15,198	
	2,428	-	2,428	1957	14,275	
	2,518	-	2,518	1958	5,341	
12.	1,038	-	1,038	1954	4,140	Dance Studio Manager
	1,220	-	1,220	1955	2,576	
	1,615	-	1,615	1956	3,582	
13.	12,248	2,505	9,743	1955	13,501	Retail Merchant, Investor
	14,640	2,901	11,739	1956	26,180	
	9,209	3,137	6,072	1957	(17,968)	
14.	16,703	-	16,703	1955	No Ret.	Retired
	18,852	-	18,852	1956		
	19,100	-	19,100	1957		
15.	866	113	753	1954	440	Chiropractor
	1,189	114	1,075	1955	462	
	1,987	655	1,332	1956	2,424	
	2,618	1,105	1,513	1957	1,512	
16.	3,590	480	3,110	1954	6,186	Dentist
	4,727	520	4,207	1955	4,400	
	5,402	650	4,752	1956	7,720	
	6,305	732	5,573	1957	8,337	
	7,283	1,991	5,292	1958	11,084	
17.	2,648	-	2,648	1954	6,207	Service Station Appliances
	4,484	-	4,484	1955	6,185	
	4,514	-	4,514	1956	6,613	
	4,584	-	4,584	1957	6,805	
18.	1,893	-	1,893	1954	2,216	Dentist
	1,952	-	1,952	1955	2,101	
	2,129	-	2,129	1956	2,133	
	2,257	-	2,257	1957	780	

Case No.	Dividends and/or Interest: Determined to be Reportable	Reported on Return	Under-reported	Tax year	Adjusted Gross Income Per Return	Occupation of Taxpayer
19.	$ 4,181	$ 51	$ 4,130	1953	$(21,027)	Dry Cleaning and Laundry
	3,800	-	3,800	1954	(15,041)	
	4,666	2,100	2,566	1955	(5,834)	
	8,499	1,556	6,943	1956	(735)	
	9,725	8,600	1,125	1957	14,079	
20.	6,916	1,533	5,232	1954	465	Fruit Dealer and Money Lender
	6,233	1,109	5,124	1955	(14)	
	7,088	897	6,191	1956	(524)	
	8,435	871	7,564	1957	(612)	
	8,906	1,439	7,467	1958	(483)	
21.	24,666	13,729	10,937	1954	5,490	Loan Business
	31,771	19,827	11,944	1955	13,540	
	31,612	20,462	11,150	1956	14,089	
	29,168	22,176	6,992	1957	16,561	
22.	8,125	1,723	6,402	1954	9,032	Attorney and Farming Rentals
	11,417	1,252	10,165	1955	12,056	
	9,121	1,826	7,295	1956	19,431	
23.	2,602	-	2,602	1954	5,680	Naval Officer
	2,082	680	2,762	1955	8,250	
24.	3,621	270	3,351	1956	4,089	Ice Company Operator
	3,960	510	3,450	1957	6,677	
25.	2,082	-	2,082	1954	No Ret.	Attorney
	1,741	-	1,741	1955		
26.	855	-	855	1954	No Ret.	Insurance Business
	1,811	-	1,811	1955		
	3,016	-	3,016	1956		
	5,837	-	5,837	1957		
27.	2,427	813	1,614	1954	3,781	Salesman
	2,939	998	1,941	1955	3,416	
	3,334	1,214	2,120	1956	3,753	
	3,848	1,633	2,215	1957	3,545	
	3,909	1,942	1,967	1958	4,834	

Case No.	Dividends and/or Interest: Determined to be Reportable	Reported on Return	Under-reported	Tax year	Adjusted Gross Income Per Return	Occupation of Taxpayer
28.	$ 3,458	$ 806	$ 2,652	1954	$ 3,412	Funeral Home Operator
	5,250	757	4,493	1955	5,068	
	3,992	1,083	2,909	1956	3,935	
	4,030	1,383	2,647	1957	577	
29.	990	-	990	1955	3,997	Funeral Director
	2,086	-	2,086	1956	6,003	
	3,076	-	3,076	1957	6,191	
30.	8,936	-	8,936	1954	3,924	Engineer Investor
	14,681	-	14,681	1955	4,914	
	23,338	-	23,338	1956	4,380	
31.	1,059	-	1,059	1954	No Ret.	Attorney
	1,689	-	1,689	1955		
	1,975	-	1,975	1956		
	1,779	-	1,779	1957		
32.	4,489	397	4,092	1954	22,431	Partner-Bottling Co.
	7,562	2,292	5,270	1955	34,020	
33.	21,474	10,421	11,053	1954	6,886	Investor
	21,197	9,759	11,438	1955	9,455	
	24,675	13,568	11,107	1956	11,450	
34.	1,278	192	1,086	1955	12,999	Doctor
	1,439	137	1,302	1956	11,530	
	1,347	130	1,217	1957	10,981	
	1,477	127	1,350	1958	12,841	

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Table 7. Selected Examples of Substantial Under-reporting of Dividends and/or Interest in 1960 Fraud Prosecution Cases 1/

Case No.	Dividends and/or Interest: Determined to be Reportable	Dividends and/or Interest: Reported on Return	Dividends and/or Interest: Under-reported	Tax Year	Adjusted Gross Income Per Return	Occupation of Taxpayer
1	$ 6,110	$ 250	$ 5,860	1954	$ 1,582	Farmer
	5,779	0	5,779	1955	1,641	
	5,705	0	5,705	1956	1,605	
	5,388	0	5,388	1957	1,621	
2	4,490	397	4,093	1954	22,432	Ptr. Theater
3	1,962	871	1,091	1954	3,109	Maintenance Service
	1,994	837	1,157	1955	4,079	
	927	0	927	1956	4,912	
	2,194	1,686	508	1957	8,379	
4	3,143	0	3,143	1953	1,490	Broker-Sales
	5,695	0	5,695	1954	1,501	
	6,046	0	6,046	1955	1,402	
5	7,371	0	7,371	1953	4,366	Home Builder and Farmer
	10,459	0	10,459	1954	24,464	
6	16,321	3,449	12,872	1955	19,062	Furniture Store
7	7,009	3,030	3,979	1951	11,766	Attorney
	5,947	3,439	2,508	1952	12,563	
	5,631	2,899	2,732	1953	(831)	
	11,725	7,709	4,016	1954	20,841	
8	20,785	5,183	15,602	1954	8,403	Rental Property
	45,682	9,466	36,216	1955	33,776	
	47,689	29,046	18,643	1956	45,069	
9	3,186	75	3,111	1954	4,249	Dentist
	4,283	75	4,208	1955	4,400	
	4,828	75	4,753	1956	7,720	
	5,665	92	5,573	1957	8,322	
	5,292	0	5,292	1958	10,892	
10	1,396	0	1,396	1953	3,289	Self-Employed
	1,576	0	1,576	1954	2,764	
	1,835	0	1,835	1955	2,695	
	2,400	0	2,400	1956	4,240	

Convictions secured during 1960.

Table 7. (Continued)

Case No.	Dividends and/or Interest: Determined to be Reportable	Dividends and/or Interest: Reported on Return	Dividends and/or Interest: Underreported	Tax Year	Adjusted Gross Income Per Return	Occupation of Taxpayer
11	$ 2,377	$ 0	$ 2,377	1953	$ (863)	Cattle Dealer
	3,610	0	3,610	1954	4,736	
12	12,473	6,128	6,345	1955	80,661	Executive
	15,216	6,442	8,774	1956	79,800	
	21,777	18,947	2,830	1957	96,223	
13	2,961	1,961	1,000	1953	12,438	Salesman and Salesgirl
	3,171	2,035	1,136	1954	12,637	
	3,677	2,269	1,408	1955	10,400	
14	100,457	0	100,457	1953	?	Real Estate
	78,673	0	78,673	1954	9,554	
	69,086	0	69,086	1955	8,558	
	74,496	22,649	51,847	1956	382,043	
15	3,140	0	3,140	1953	2,000	Extractor
	3,109	0	3,109	1954	2,117	
	3,269	755	2,514	1955	2,945	
	3,231	1,420	1,811	1956	1,557	
16	28,693	0	28,693	1953	No Ret.	Not Stated (Delinquent Return)
	26,143	0	26,143	1954	70,347	
17	1,778	325	1,453	1953	1,660	Farming
	1,939	350	1,589	1954	2,124	
	2,341	365	1,976	1955	1,960	
18	2,347	1,119	1,229	1956	7,450	Not Stated
19	7,163	0	7,163	1955	16,876	Farmer
	12,827	0	12,827	1956	16,239	
20	14,647	0	14,647	1952	No Ret.	Not Stated
	14,989	0	14,989	1953	"	
	15,412	0	15,412	1954	"	
	16,704	0	16,704	1955	"	
	18,852	0	18,852	1956	"	
	19,101	0	19,101	1957	"	

Table 7. (Continued)

Case No.	Dividends and/or Interest: Determined to be Reportable	Dividends and/or Interest: Reported on Return	Dividends and/or Interest: Under-reported	Tax Year	Adjusted Gross Income Per Return	Occupation of Taxpayer
21	$ 11,718	$ 0	$ 11,718	1954	No. Ret.	Not Stated
	15,266	0	15,266	1955	"	
22	3,132	0	3,132	1955	No Ret.	Not Stated
	2,640	0	2,640	1956	"	
23	973	0	973	1953	$ 5,800	Store Manager
	1,117	0	1,117	1954	7,446	
	1,423	0	1,423	1955	7,652	
	3,609	0	3,609	1956	24,659	
24	422	0	422	1953	?	Farming
	1,669	658	1,011	1954	3,923	
	2,520	792	1,728	1955	2,907	
	2,424	1,436	988	1956	424	
25	2,239	0	2,239	1953	8,615	Tax Assessor and Movie Operator
	2,486	0	2,486	1954	9,045	
	3,113	0	3,113	1955	10,638	
26	7,504	4,976	2,528	1952	16,161	Misc. Warehousin and Trading
	5,303	5,271	32	1953	14,409	
	7,456	5,646	1,810	1954	15,969	
27	2,334	361	1,973	1954	12,212	Physician and Surgeon
	2,086	611	1,975	1955	13,668	
	3,203	2,310	893	1956	14,203	
	3,664	2,580	1,084	1957	16,336	
	3,714	2,697	1,017	1958	15,445	
28	4,550	0	4,550	1953	1,632	Retired Mail Carrier
	4,654	0	4,654	1954	1,632	
	6,010	0	6,010	1955	1,664	
	7,308	0	7,308	1956	1,824	
29	12,721	4,043	8,678	1954	8,514	Dentist
	12,082	6,469	5,613	1955	11,247	
	12,877	6,892	5,985	1956	11,950	
	14,902	8,3[illegible]	6,512	1957	13,612	
30	5,504	523	4,981	1953	7,863	Not Stated
	7,128	873	6,255	1954	9,038	
	8,453	1,023	7,430	1955	8,558	
	10,262	1,523	8,739	1956	6,761	

Table 7. (Concluded)

Case No.	Dividends and/or Interest: Determined to be Reportable	Reported on Return	Under-reported	Tax Year	Adjusted Gross Income Per Return	Occupation of Taxpayer
31	$ 7,226	$ 121	$ 7,105	1953	$ 3,288	Self-Employed
	6,706	1,508	5,198	1954	7,600	
	9,811	164	9,647	1955	10,652	
	18,671	336	18,335	1956	10,762	
	15,848	476	15,372	1957	13,610	
32	117,367	89,940	27,427	1953	89,940	Investments
	113,671	93,532	20,139	1954	409,516	
	66,592	60,325	6,267	1955	163,899	
	112,950	91,410	21,540	1956	140,116	
33	5,515	2,548	2,967	1953	6,105	Printer
	4,903	2,023	2,880	1954	6,494	
	6,015	2,885	3,130	1955	7,846	
	6,803	3,426	3,377	1956	9,100	

Internal Revenue Service
Research Division

April 2, 1962

Table 8. Selected Examples of Substantial Under-reporting of Interest Income Uncovered in 1960 Information Document Survey 1/

Case No.	Interest Covered by Information Documents: Determined to be Reportable	Reported on Return	Under-reported	Adjusted Gross Income Per Return	Payer of Under-Reported Interest
1.	$ 1,254	$ -	$ 1,254	$ 1,373	Commercial Bank
2.	1,055	75	980	120,305	Savings & Loan Assn.
3.	3,235	-	3,235	7,034	Corporation
4	1,211	-	1,211	No. Ret.	Commercial Bank
5.	2,598	-	2,598	No. Ret.	Corporation
6.	1,052	-	1,052	3,120	Commercial Bank
7.	1,010	-	1,010	11,736	Savings & Loan Assn.
8	1,468	-	1,468	102,330	Commercial Bank
9.	946	-	946	9,163	Life Insurance Co.
10.	1,015	-	1,015	373	Commercial Bank
11.	2,263	-	2,263	7,549	Credit Union
12.	1,552	-	1,552	5,681	Savings & Loan Assns.
13.	2,875	-	2,875	6,902	Corporation
14.	1,028	-	1,028	5,913	Commercial Bank
15.	2,152	-	2,152	No. Ret.	Life Insurance Co.
16.	1,311	-	1,311	No. Ret.	Commercial Bank
17.	2,636	-	2,636	6,534	Commercial Bank
18.	1,227	-	1,227	21,084	Commercial Bank
19.	1,962	-	1,962	55,062	Commercial Bank
20.	1,200	-	1,200	54,620	Corporation
21.	6,970	-	6,970	No. Ret.	Corporation

Internal Revenue Service
Research Division

April 2, 1962

1/ Underreporting confirmed by audit.

Table 9. Selected Examples of Substantial Under-reporting of Dividend Income Uncovered in 1960 Information Document Survey 1/

Case No.	Dividends Covered By Information Documents: Determined to be Reportable	Reported on Return	Under-reported	Adjusted Gross Income Per Return
1.	$ 1,250	$ -	$ 1,250	$ 354
2.	3,962	2,984	978	2,984
3.	2,520	1,317	1,203	93,893
4.	5,804	4,642	1,162	7,166
5.	5,383	1,983	3,400	6,764
6.	1,764	583	1,181	15,256
7.	5,367	4,387	980	8,366
8.	14,156	9,845	4,311	49,274
9.	2,724	1,603	1,121	2,231
10.	18,864	17,496	1,368	45,884
11.	16,814	15,890	924	34,161
12.	18,075	12,220	5,855	18,932
13.	4,544	3,278	1,266	85,481
14.	1,742	905	837	3,247
15.	974	-	974	No Ret.
16.	25,238	23,728	1,510	55,235
17.	947	-	947	No Ret.
18.	3,161	1,974	1,187	5,084
19.	5,507	-	5,507	No Ret.
20.	3,515	-	3,515	3,562

Internal Revenue Service
Research Division

April 2 1962

1/ Underreporting confirmed by audit.

Table 10

Comparative Cost and Revenue Data

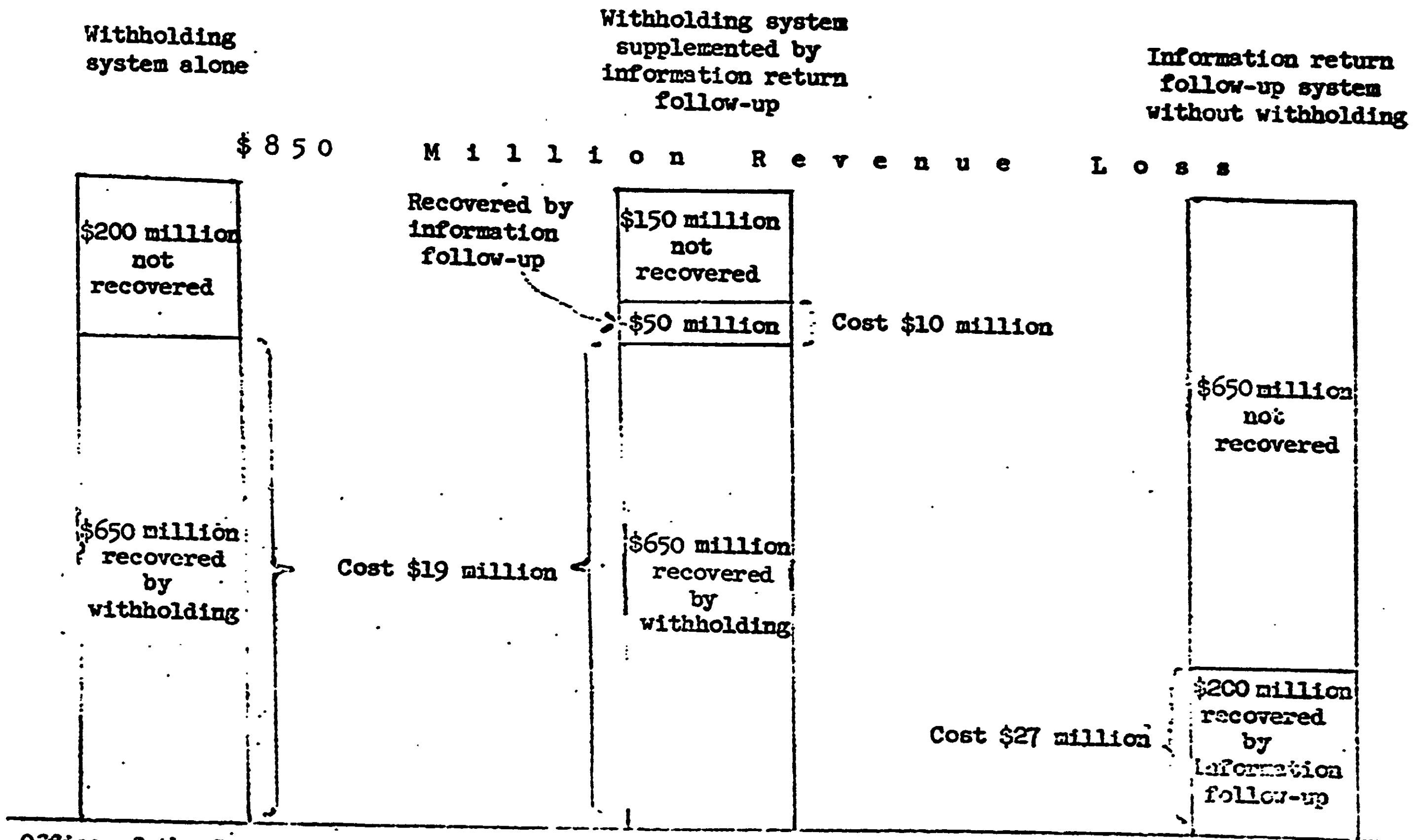
(millions of dollars)

	Withholding system alone	Withholding system supplemented by information return follow-up	Information follow-up system without withholding
A. Costs			
1. Data processing	$16.6	$19.2	$ 5.5
2. Enforcement -withholding follow-up	2.4	2.4	-
3. Enforcement - information follow-up	-	7.4	21.3
Total Costs	$19.0	$29.0	$26.8
B. Revenue			
1. Total estimated gap	$850	$850	$850
2. Estimated recovery	650	700	200
3. Remaining gap	200	150	650

Treasury Department

April 2, 1962

Chart A Effectiveness of Alternative Systems in Recovery of $850 Million Revenue Loss



Office of the Secretary of the Treasury
Office of Tax Analysis

April 2, 1962

EXHIBIT II - Appendix

Excerpts from a speech entitled "Automatic Data Processing and Withholding for Dividends and Interest" by Commissioner of Internal Revenue Mortimer M. Caplin delivered before Section on Taxation, New York State Bar Association Annual Meeting, New York, Thursday, January 25, 1962.

". . . Because we expect ADP to be such an extremely valuable tool in tax administration, we frequently are asked why it won't eliminate the need for a withholding system for income tax on dividends and interest. . . ."

". . . Those who favor the former and who oppose withholding urge that we go after the $850 million [revenue loss] with machine and muscle. The structural underpinning for this proposal consists of information reporting tied in with and reinforced by automatic data processing. Payers of dividends and interest, the argument goes, report these payments to the Service on Forms 1099. We then feed the 1099 data into our ADP system, along with what is reported on individual tax returns, and compare them. If a discrepancy turns up--if the 1099 shows that he received more dividends or interest than he reported--we go after him.

Up to now, the argument continues, we've been unable fully to exploit information reporting because we didn't have ADP and we didn't have taxpayer account numbers to enable the machines to distinguish one John Smith from thousands of others. Now, however, we're beginning to move on ADP, and we are in the process of assembling taxpayer account numbers. Thus, for the first time, we will have the capability to take on a full matching operation of 1099's against 1040's.

Why, then, do we need withholding? . . . The answer to this question, as we shall see, is that an information reporting system alone, even a well-developed one, would be burdensome and expensive to business and Government out of all proportion to the effect it would have on the reporting gap.

Under such an approach sound information reporting would require:

(1) Maintaining dividend-reporting requirements at the present $10 floor. (This means about 100 million 1099's on dividends each year.)
(2) Lowering the interest-reporting floor. (There is wide agreement that the current interest-reporting floor of $600 would have to come down substantially. If it were dropped to $10, the number of 1099's on interest would go from the present half-million to 150 million--50 million on savings accounts, 60 million on Series E bonds and 40 million on Federal and corporate coupons and registered bonds. Counting dividend 1099's, it would amount to 250 million 1099's in all. The 1099's on coupon bonds,

incidentally, would not necessarily cover those sold between interest payment dates, and the value of these particular 1099's, as you might suspect, would be questionable because they would not reflect the true allocation of interest between the man who redeems the coupon and the man he bought the bond from.)

(3) Encouraging notices from payors to payees. Such reminders and stimulants to voluntary compliance would have to be introduced into a sound information-reporting system.

These are some of the "paper" consequences of the information-reporting alternative to withholding. The cost of simply processing 250 million 1099's into our ADP system, incidentally, would come to $5.5 million a year. And, after we finished the processing, the entire operation would have directly produced for us in tax not one dollar. We could, however, expect the psychological effect of broader information reporting and electronic matching to bring about some improvement in voluntary compliance.

A match of the 1099's against tax returns would only identify the individual who apparently hadn't properly reported all dividend-interest income. It would only show us where the potential tax was. Information reporting and ADP obviously do not collect the tax. Further positive action would be required of us--through correspondence, office auditors, internal revenue agents and revenue officers.

I am not sure that those who favor this approach over withholding fully appreciate its formidable dimensions and effects. Let's consider for a moment what's involved in a system combining full information reporting and ADP, along with full enforcement follow-up on leads:

(1) Administrative problems:
In the first place, it's one thing to think in terms of the capacity for 100% matching and follow-up enforcement operation and quite another thing, as a practical administrative proposition, to go forward with an undertaking of such heroic proportions in terms of paper, machines and manpower.

(2) Huge correspondence:
This kind of a saturation approach, with full matching and enforcement follow-up, could be expected to produce several million underreporting leads. Most of these leads, individually, would involve small amounts of a level that would entail exorbitant collection costs--even if we went after them with correspondence. Collectively, however, they add up to a great deal of tax. Going after these small amounts by correspondence would mean dropping a small blizzard of paper on the country--and inviting a similar response in return.

(3) Doubled office audit:
At the same time, for larger amounts of underreporting, we would use office auditors. This would mean asking taxpayers to leave their work and come into Revenue Service offices for an accounting and explanation of apparent discrepancies between 1099's and tax returns. A full office audit follow-up, incidentally, would require us to more than double our office auditor force.

(4) Expanded field audit:
Returns indicating the largest amounts of dividend-interest underreporting, and possibly other inadequacies, would be assigned to the internal revenue agents for follow-through investigations in taxpayers' homes and offices. This would mean at least a 10% increase in our agent force.

(5) Collection difficulties:
Finally, as part of this system, we would have to hire more revenue officers to locate individuals who received dividend-interest income, but who apparently failed to file returns.

To do this job right--to produce an appreciable effect on the revenue gap-- we would have to bring to bear so much muscle on dividends and interest alone that our over-all enforcement program would be thrown far out of kilter. And this is not to mention the unrealistic cost of this kind of approach.

Selective Program

To reduce the scope and costs of a system of information reporting and ADP to more realistic, manageable limits, we would have to cut it back drastically. This would mean restricting our audits generally to the most productive leads, the big amounts, and letting most of the rest go. Even this kind of a trimmed-down approach, however, would cost us about $21 million in enforcement manpower alone--manpower which would have to be diverted from other areas where it might be much more productive in terms of revenue yield and in stimulating voluntary compliance.

Now let's see what the combination of information reporting and ADP would produce for us in revenue--what it would do to the $850 million gap. We have no solid platform of experience with enforcement drives on dividends and interest alone from which we can build reliable estimates. We do, however, have estimates of how much revenue is produced by office audit and field examination. We also can project how many of these audits and examinations we could make with $10 reporting floors. On these bases, we estimate, very roughly, that an information reporting-ADP system of realistic dimensions would close the revenue gap by less than one-fourth, leaving more than three-fourths unclosed. This estimated pickup, incidentally, represents the

total additional tax from enforcement--from adjustments which would include items in addition to dividends and interest. Once we undertake an audit from a dividend or interest lead, we naturally go on to a scrutiny of other items. Assuming, however, that the entire pickup is from dividends and interest alone, as most of it probably would be, that would still leave us more than 75 percent short of the ultimate goal--with well over one-half billion dollars of gap still remaining.

One-fourth is better than nothing, but I do not believe it is good enough. For that reason we have taken a look at what withholding would do to close the gap and what it would cost. Because so much has been said about the effects of withholding on business and on individuals, we also have studied its probable impact--how it would work.

WITHHOLDING

I have been taking a hard look at withholding for about a year. We have examined the subject in broad outline and in depth. We have gone into it on our own and with industry. We have read and heard some hard truths on both sides of the subject, and some half-truths, too. During this process I have reached some judgments on withholding which I want to pass on to you now.

At the outset, let me say that ADP complements withholding--one does not replace the other.

At the same time, we recognize that withholding presents problems, just as information reporting-ADP does. I do not intend to sugar-coat withholding and pass it off as a palatable, easy-to-take remedy for a serious fiscal ailment. One item obviously is costs to payers. There is not much doubt that withholding on dividends and interest would add something to payers' processing costs. They would be offset in some measure, however, by the lower information reporting costs under withholding than would be needed under full information reporting. Also, under the draft bill, payers may retain the withheld tax until the end of the month following the quarter in which the dividends or interest involved are payable.

I do not believe, therefore, that costs to payers are the significant problem. The principal problems to payers, instead, are mainly administrative in character--of a kind associated with getting any new show on the road. Once we got it moving things would fall into place, and the problems would diminish.

I give you wage withholding as a case in point--an operation of much greater magnitude and complexity which, within two or three years after its inception, became a smoothly functioning fact of our fiscal life--a fact for which we all can be grateful.

Administration

On the administrative or operational side of the subject, withholding is not all minus. It has some plus features, too. A conspicuous plus feature of withholding is its much lower enforcement costs--about $2.4 million compared to $21.3 million under information reporting. The reason is simple: withholding is, almost by definition, self-enforcing, especially at the small-amount levels where our enforcement costs are disproportionately high in terms of yield. Withholding is tailor-made to pick up these small amounts which add up to a large portion of the $850 million gap.

A somewhat related consideration is that a withholding structure is essentially a mechanical operation; and machines and the complementary clerical force are relatively easy to acquire. Information reporting, on the other hand, represents not only a machine, paper-pushing operation of staggering proportions, but calls for the deployment of large numbers of highly technical manpower for a massive follow-through on leads generated by machines. These technicians--internal revenue agents and office auditors, for the most part--are not easy to come by; and it takes at least two to three years to train them to journeyman proficiency.

A third consideration is that withholding would free much of our enforcement personnel now pinned down on dividends and interest for assignments to areas which require more audit attention and where withholding is not feasible. So much for administration.

Revenue Effects.

In terms of revenue effects, the two competing systems, as you might expect, present striking differences. We estimated that information reporting would close one-fourth of the gap. Withholding, in sharp contrast, would close two-thirds--about 65 percent, according to Treasury estimates. About $410 million alone, which we are not getting today, would be recovered automatically by withholding at a 16-2/3 percent withholding rate. About $120 million more would come from heightened voluntary compliance. This amounts to a total of about $530 million in additional tax.

This arithmetic alone adds up to a rather compelling argument in support of withholding. More is collected at a much lower operating cost.

Effect on Taxpayers and Tax System.

Now that we have translated withholding in terms of dollars and cents, I want to examine it in terms of its effect on taxpayers and on the tax system.

Broadly, the plan is designed to withhold and retain tax on dividend and interest income only from people who would have to pay the withheld tax. For a closer look, let's examine a few blows--some high and some low--that have been thrown at withholding. It is said:

"Withholding would be burdensome to payers."

Withholding, of course, would put some burden on payers of dividends and interest. It is a burden, however, which is not as great in terms of magnitude and complexity as wage withholding--and it is one which can generally be undertaken without much difficulty by our industrial and financial communities. To the payer, withholding means fewer information returns than would be involved in a full information reporting-ADP system, and no reminders to payees would be necessary. Finally, the single withholding rate . . . would do much to simplify the operation for payers.

"Withholding would create refund headaches."

Refunding presents no real problems. We would have quarterly refunds, which would be new, but we could accomplish this with relatively little break in stride under our existing refunding program. In fiscal 1961, we distributed over 40 million refunds under wage withholding--far more than we would ever be called on to process under dividend-interest withholding. (A great many of these 40 million refund cases were due, I might add, to the deliberate understatement of exemptions by taxpayers who wanted a refund instead of a tax bill at their annual reckoning.)

"Withholding would impose a tax on dividends and interest which, it is suggested, have not heretofore been subject to tax."

The simple answer to this, of course, is that the dividends and interest we are talking about are already taxable. Withholding legislation would not impose the tax; it would simply provide a more efficient way of collecting it.

"Withholding would impose hardships on people with limited incomes, people living exclusively or mainly on dividends and interest."

The House Ways and Means Committee has introduced into the draft bill a variety of relief provisions calculated to minimize these hardships and virtually eliminate them in a great many cases.

The serious criticisms leveled at withholding have been thoroughly considered. Many of them, I am pleased to say, have found expression in the draft bill on withholding which was released by the House Ways and Means Committee last summer for public study and comment.

Equity of Withholding.

This leads me now to the equitable side of withholding--the element of justice that I mentioned earlier. All taxpayers--individuals, corporations, trusts--voluntarily assessed themselves and paid 97 percent of the $94.4 billi in revenues collected last year. The other 3 percent came from direct enforcement. This is part of the very conspicuous evidence that the heavy majority of our taxpayers pay their full tax liability.

They pay their taxes in full measure under a deeply engrained tradition of voluntary compliance--the most valuable asset we have in our tax system. If that asset ever begins to deteriorate, we would be in deep, serious fiscal trouble. It is essential, therefore, that voluntary compliance be kept strong and flourishing and be pushed to even higher levels. In this connection, all of us are under an obligation to those who pay their taxes faithfully to see that others pay theirs, and under similar conditions.

An individual whose income is exclusively from wages and salaries is withheld on. Why, in the name of common justice, shouldn't dividend-interest income also be withheld on? We do not promote voluntary compliance by tolerating a condition, year after year, under which most people pay and watch others, similarly situated under the tax laws, get a free ride--or ride at a reduced fare. Such a condition is not only fiscally unsound--it is equitably and morally unsound.

Other nations have decided in favor of withholding taxes on dividends and interest. For example, Belgium, France, Japan and West Germany withhold on both dividends and interest. In the Netherlands, withholding extends to dividends alone. Italy and the United Kingdom withhold only on interest. This foreign experience--like that found in depreciation and investment credits provide helpful comparisons in appraising the advisability and feasibility of such a new tax program.

To sum up, our essential, immediate problem is the dividend-interest tax gap--$850 million. Related, but equally critical, problem is the strain that the very existence of this gap puts on voluntary compliance.

On balance, I see withholding as the most workable, businesslike approach for narrowing this gap. Further, I see withholding as a measure which will stimulate better voluntary compliance and help strengthen our entire Federal tax system. And I see withholding as an opportunity to produce revenues critically needed to meet the heavy revenue demands on us generated by unavoidable domestic and global forces. . . ."

EXHIBIT III

TAXATION OF FOREIGN INCOME AND INVESTMENT

A. Taxation of Income of U. S. Subsidiaries Abroad: Economic Considerations

B. Income Earned Abroad by Individuals

C. Data on Tax Haven Subsidiaries

D. Administrative Problems Connected with the Auditing of Cases Involving Controlled Foreign Corporations

E. Separate Limitation on Foreign Tax Credit with Respect to Investment Income

F. Foreign Investment Companies

EXHIBIT III

THE TAXATION OF INCOME OF U.S. SUBSIDIARIES ABROAD:

ECONOMIC CONSIDERATIONS

SUMMARY STATEMENT

1. Neutrality is a fundamental principle of taxation in the United States. The purpose of neutrality is to promote equity and the most efficient possible allocation of existing resources. Ideally corporate tax rates should be everywhere the same, assuming roughly equivalent government services. We cannot control foreign tax rates and the fact that they may contribute to inequities. But we can prevent the American tax structure from contributing to the artificial diversion of funds into low-tax areas, by taxing the income of our overseas subsidiaries at the same rates as are applicable to income earned at home. The burden of proof for not following the general principle of tax neutrality should be on those who wish to continue a departure from that neutrality.

2. The arguments advanced for preserving tax preferences which favor foreign over home investment, as they relate to the national interest and not to the particular interests of individual business firms, are that tax inducements stimulate foreign investment and that this foreign investment in turn (a) stimulates income, employment, and growth in this country, and (b) improves our balance of payments.

3. The evidence which has been offered from time to time by particular companies in support of the national interest arguments with respect to employment and the balance of payments, in particular with respect to exports generated, runs counter to the evidence for the economy as a whole, for various reasons: (1) the behavior of one company, or even a selected group of companies, is not necessarily typical; (2) the data on capital outflow as reported by individual companies often include only purchases of stock in foreign subsidiaries, that is do not include net increases in inter-company accounts which form a large part of the total capital outflow reported in Department of Commerce data; (3) even if all the measurable inflows and outflows are correctly included in such data, one important element is inevitably excluded because it cannot be readily measured -- that is sales by foreign subsidiaries abroad which displace actual or potential U. S. exports; (4) the illustrations are frequently on a world-wide basis, whereas the Treasury proposal would affect only income earned in developed countries; (5) most important of all, the two types of

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flows being compared -- the outflow of new capital and the dividend and export receipts for a given year or period -- are in good part not related to one another: the dividends, and most of the export receipts, of one year or period, have been generated by investment over many years prior to the current year or period; that portion of the inflows which has been generated by past investment, then, has nothing whatsoever to do with the outflow of the current year or period in question.

4. The available data on the economy as a whole indicate the following. A dollar invested in manufacturing in Europe returns only 4 cents worth of "net exports" annually, and a dollar invested in manufacturing in Europe and Canada together, divided in the proportion of 70:30, respectively (which has been the ratio of new capital outflow in recent years), returns only 8 cents worth of "net exports" annually. In contrast to this, a dollar invested in less developed countries of the world yields over 40 cents worth of "net exports" annually. The data on which these results are based do not take account of the possibility that there may be some exports which are not sold to or through foreign subsidiaries (the sales which are used for our "net export" ratio) but are in some way nevertheless dependent upon the existence of subsidiaries; and they exclude the possibility that a substantial amount of sales by subsidiaries abroad, particularly in developed countries, may displace U. S. exports. But in view of the fact that these two major exclusions might at least tend to offset each other, and that more likely the displacement factor is the larger of the two, we believe that the above "net export" ratios if anything overstate the export content of investment in developed countries. If only a little more than one percent of the sales by foreign subsidiaries of goods they produce abroad displace U. S. exports, the "net export" factor is eliminated; if 3 percent displace U. S. exports, any reasonable estimate of the "related export" factor is offset as well.

5. The low "export content" of investment in Europe, or Europe and Canada considered together, means that elimination of tax deferral in these areas would almost inevitably have a favorable effect on income, employment, and growth here at home. For even if only a relatively small fraction of the dollars deterred from moving abroad as a result of elimination of the tax preference accorded foreign income were invested at home, the net effect of the switch would be positive.

6. When all inflows which are related to a given capital outflow are taken into account (including dividend income, income from fees and royalties, and receipts from the sale of exports minus payments for imports), the evidence available indicates that our overall

balance of payments situation will be improved as a result of eliminating tax preferences, for at least 10 to 15 years ahead. For the period 1952 to 1960 it is clear that new capital outflow to Canada and Western Europe exceeded inflows related to that outflow in every year after 1953, i.e., that there was a cumulative widening of the deficit as a result of private foreign investment in these regions. To cut back on a small amount of tax-induced investment can hardly do damage to our balance of payments position, and should improve it. When account is taken of the fact that income remitted to this country should increase with elimination of the tax incentive to leave it overseas, the favorable effect becomes still more pronounced. While any estimate of how much of a difference it should make in our balance of payments position is fraught with hazards, a reasonable "guess" would be that there would be a net favorable effect of $200-400 million in the early years following the new legislation. This improvement would have erased between one-third and two-thirds of the $600 million deficit in the basic balance of 1961.

7. The question of what effect elimination of tax deferral may have on the competitive position of individual firms must be thought of in this context of national interest. But even if viewed from the aspect of the individual firm, the effect could hardly be as severe as is sometimes imagined. First, the fact often referred to that some subsidiaries pay high indirect taxes abroad and so elimination of deferral may mean that total taxes are in excess of 52 percent of income is not relevant in assessing the effect on a firm's competitive position. Such taxes are treated as a part of operating costs, they are not borne out of profits, and they are charged to foreign competitors as well as to American foreign subsidiaries. Second, so far as a subsidiary's position in third-country markets in competition with other foreign firms is concerned, it must be remembered that most other developed countries impose exchange control restrictions on new investment by their nationals, as well as on repatriation of earnings from their foreign investments. Such controls can be far more burdensome to a firm than higher tax rates. Third, many foreign subsidiaries may not be unfairly affected at all by elimination of tax deferral -- it may, for example, simply limit diversification, or the subsidiary may have sufficiently substantial real cost advantages that it will still be able to grow relative to its competitors even while paying somewhat higher taxes. Some foreign subsidiaries, on the other hand, may experience a decline in retained earnings consequent upon elimination of tax deferral--a reduction which reduces their rate of expansion and slowly cuts in to their market share abroad. Faced

with this situation, the subsidiary could offset this by (a) reducing the level of dividends paid to stockholders, or (b) borrowing funds from the parent company or from elsewhere. Whether or not it chooses to do this would depend, in the last analysis, upon the relative profitability of alternative investment opportunities--for example in the United States. If the rate of return abroad over a number of years proved to be greater than the rate of return at home when the tax on both incomes was the same, it would maintain and expand its position abroad relative to its position at home. If this were not the case, it would do the reverse. In short if elimination of tax deferral hurts at all, it will do so only by limiting the growth of foreign subsidiaries and thus possibly reducing its market share vis-a-vis foreign competitors. But this would in fact be the end result only for those firms for whom the tax inducement was or is an important reason for investing abroad.

8. The issue with respect to the taxation of foreign income thus would seem to come to the following. We must ask ourselves whether or not it is in the national interest of the United States to subsidize, through tax preferences, the growth and/or maintenance of market shares of some of our subsidiaries which produce abroad, in order that these foreign subsidiaries may retain their existing competitive position, at the expense of growth of production here in this country. This subsidization would at the same time also result in giving unneeded tax benefits to other foreign subsidiaries which do not need tax benefits to remain competitive. The only justification for doing this is that in the very long run subsidization _may_ contribute positively to our balance of payments liquidity position, although it will clearly worsen our balance of payments liquidity position over at least the next 10 to 15 years.

EXHIBIT III

THE TAXATION OF INCOME OF U. S. SUBSIDIARIES ABROAD:

ECONOMIC CONSIDERATIONS

MAIN STATEMENT

The Concept of Neutrality

One of the most fundamental of the guiding principles in American income taxation is that there should be equality in the tax treatment of similar groups of taxpayers. Applied to corporations, this principle must be interpreted to mean that the income of any branch or subsidiary of an American corporation operating overseas should as far as possible be subject to the same corporate income tax rates as the income of any branch or subsidiary operating at home.

Justification of this basic principle, as a principle, is made on two grounds: (1) it is "fair" or "equitable"; (2) it promotes the most efficient possible allocation of our own and world resources. Ideally, given the existence of corporate income taxes, the situation which in general would least interfere with efficient resource allocation, and would be most equitable, would be one in which corporate tax rates would be everywhere the same, assuming that government services are comparable. We cannot control tax rates established by foreign governments any more than they can control ours. We thus cannot alter the fact that a relatively low corporate income tax in certain countries of the world artificially induces capital to stay in that country and artificially induces some other capital to come in from the outside, even though such investment may not be justified on true economic grounds, i.e., on the basis of relative rates of return on investment before taxes, a measure which embodies relative costs of production, future market possibilities, risks, etc. But by taxing the income of our overseas subsidiaries at the same corporate rate as domestic activities in the same way that overseas branches of U. S. firms are now generally taxed in the same manner as domestic branches, we can at least prevent the American tax structure from contributing to the artificial diversion of funds into low-tax areas.

Breaches in the Neutrality Concept

1. A failure to "gross-up" dividends

Historically, we have not adhered to the tax neutrality concept as it relates to domestic and foreign corporate income. Ever since 1913 we have taxed the income of foreign subsidiaries only when it

was remitted to the United States as a dividend. In addition we have not taxed that income at the full existing rate, with a credit for foreign income taxes paid by the subsidiary, but rather have taxed the dividend at the full rate, allowing credit for the percentage of income paid in foreign taxes times this dividend, as shown in the left-hand column of Table 1. Even if all income after payment of foreign taxes is remitted as a dividend as it is earned, the foreign subsidiary will normally pay a tax equal to around 45 percent of earned income if the foreign tax rate is lower than the U. S. rate, as compared to 52 percent for a domestic subsidiary.

Table 1

The Computation of Corporate Taxes on Foreign Income

	Existing law (dollars)	Proposed law (dollars)
Profits of subsidiary	100.00	100
Foreign tax (assumed rate: 30 percent)	30.00	30
Dividend to U. S. parent	70.00	70
"Gross-up" of dividend		30
Tentative U. S. tax at 52 percent	36.40	52
Credit for foreign tax paid by subsidiary	21.00	30
Net U. S. tax	15.40	22
Combined foreign and U. S. tax	45.40	52

If the dividends are "grossed up" in computing the U. S. tax due and the foreign tax credit allowed, as illustrated in the right-hand column of Table 1, we will eliminate an unjustified tax advantage accorded income from foreign investment when that income is paid as a dividend. But to the extent that foreign tax rates are lower than the U. S. tax rate, we would still continue to grant a tax advantage to foreign income which is not distributed.

2. The deferral privilege

In deferring U. S. tax until income is remitted to this country, we are giving foreign corporations an interest-free loan equal to the U. S. foreign tax rate differential on the undistributed profits, a loan which can be profitably reinvested in plant and equipment abroad, a loan which is not available to a domestic business. Moreover, if the earnings are never remitted as dividends the "loan" becomes a permanent exemption.

If a foreign tax rate nearly approximates the U. S. tax rate, the tax advantage is relatively small. Representative statutory corporate tax rates for a number of countries are shown in Table 2. With the exception of Belgium and Italy, statutory corporate income tax rates in most developed countries appear to be over 40 percent and thus at least fairly near the existing U. S. rate. a/ But in the case of Belgium and Italy, a tax rate of approximately 30 percent offers a substantial advantage over the 52 percent U. S. rate, as can be seen from the example given in Table 3.

Table 2
Comparison of Maximum Rates of Corporate Income Taxes in Selected Countries

Country	Rate (percent)
Australia	40
Belgium	28.5 1/
Canada	50
Denmark	44 2/
France	50
West Germany	51 3/
Italy	31 4/
Japan	49 5/
Luxembourg	42
Netherlands	47 6/
Sweden	40
United Kingdom	53.5 7/

1/ Income tax paid in the previous year is deductible so that the nominal tax rate of 40 percent is reduced to approximately 28.5 percent.
2/ Because of a special deduction measured by a percentage of capital stock outstanding and allowed to all Danish corporations, the rate may be reduced to as low as 22 percent. The average rate for most corporations is 36 percent.
3/ The German corporate rate of 51 percent is reduced to approximately 22 percent if all profits are distributed.
4/ This rate of tax is increased by 15 percent on profits in excess of 6 percent of capital plus certain allowable reserves. The Italian corporate tax is limited to profits from domestic sources.
5/ The rate on distributed profits is 42 percent.
6/ The Netherlands does not impose tax on profits derived abroad.
7/ Takes account of tax rate increase--1961-62 budget.

a/ In fact, however, various studies by both the Commerce and Treasury Departments indicate that effective tax rates, as evidenced by foreign taxes actually paid by U. S. foreign subsidiaries as a (continued on next page)

Table 3

The Effective Advantage of a 30 percent Foreign Tax Rate

Investment: $500,000
Rate of return: 20 percent on previous year's capital investment
Foreign tax on income: 30 percent of earnings
Assumption: Deferred U.S. taxes used for expansion over 5-year period

	Year					
	1	2	3	4	5	6
Earnings	$100,000	$104,400	$108,994	$113,753	$118,760	$123,986
Foreign tax	30,000	31,320	32,698	34,126	35,628	
American tax ploughed back	22,000	22,968	23,797	25,026	26,127	
Capital	522,000	544,968	568,765	593,801	619,928	

In this example the firm has earned over a period of five years $569,893 or $69,893 more than it would have if it had paid the full tax on income earned at the time it was earned, as it would have had to do if it had made the same investment in the United States. If it brought that amount back in dividends at the end of five years, it would have to pay 22 percent tax on $69,893, leaving $54,517 (assuming dividends are "grossed up"). Without deferral, the firm would have earned $240,000 after taxes, which could be paid as dividends, for a five-year return of 48 percent on original investment. With deferral the firm earns $295,000 after taxes over the five-year period, for a return of approximately 60 percent. And it is currently earning $24,000 more a year, or $11,520 more a year after all taxes, than it could do with a comparable investment opportunity in this country.

a/ (continued from page 3) proportion of income earned, are often 5 percentage points or so below statutory rates, either because of special provisions in the law or because of special arrangements with the foreign government. These lower effective rates do take into account special investment incentive allowances such as are allowed in the United Kingdom, but do not take into account the fact that in recent years a more rapid write-off of plant and machinery has been allowed in many other European countries as compared with the United States, since this affects reported income and does not alter the foreign tax rate computed on the basis of that reported income. It is estimated that the proposed investment credit, and administrative depreciation revision in the United States will bring the United States much more into line with key European countries with respect to capital consumption allowances.

It is clear from this that there do exist some considerable inequities in the taxation of home and foreign income of corporate subsidiaries. But the above describes only one part of the problem. The fact of the matter is that in recent years the crevice in neutrality created by the existence of the deferral privilege as pictured above has been widened substantially by the growth of "tax haven" operations until now it is more like a canyon, and it may soon be a wide and deep valley.

3. Tax haven operations

Certain countries of the world, among them Switzerland, Panama, and various Western Hemisphere dependencies such as the Bahamas, do not tax at all, or at least tax at very low rates, corporate earnings which are attributable to activities outside their borders. This situation plus the deferral privilege has invited the establishment of what may be termed "tax haven" corporations in these regions. Profits on overseas operations may be channeled into these corporations practically free of income taxes, or at least at a very substantial reduction in taxes, on income as it is earned. The typical activities of such corporations include the handling, as middleman, of many trade transactions--the transactions may be largely paper transactions so far as the tax haven corporation is concerned or there may be a warehouse or a sales force involved--, the sale of management services, the collection of licensing and other royalty payments, the insurance and reinsurance of U. S. risks, and the like. In addition, dividends and interest may be paid these base companies from foreign subsidiaries in other countries, in a way that will involve a saving in taxes. Germany, for example, allows a substantial reduction in corporate income taxes if earnings are distributed as dividends, and clearly they may be distributed to a base company in Switzerland as well as to the parent company in the United States.

Although it is not possible to gauge accurately the full magnitude of "tax haven profits" which exist today (it is known that Commerce Department data on foreign investments do not report all of these profits, for example, and indeed may miss a substantial portion of what is involved), there is little doubt but that tax haven profits of U. S. corporations operating abroad are (a) large, and (b) growing by leaps and bounds. Undistributed earnings of U. S. subsidiaries as reported in Commerce Department data for 1960, other than those in mining, petroleum, and manufacturing, were as follows in these principal "tax haven" regions:

Switzerland	$28 million
Panama	42
W. Hemisphere dependencies	52
Total	$122 million

This was double the reported amount for 1959. And 85 percent of the earnings of these corporations were undistributed in these years as compared to 55 percent for U. S. foreign investment earnings generally. But as indicated, such data tell only part of the story. The number of American corporations organized in these countries has risen sharply since 1957, until today there are over 1,000 such corporations in Switzerland alone.

There is thus reason to believe that the "tax haven" problem is both qualitatively and quantitatively important. Qualitatively, there is established a substantial breach in the tax neutrality principle; we are here dealing with a tax differential between foreign and domestic operation not of 5 or 10 percentage points, but of 40-50 percentage points, and clearly the existence of such a differential provides a substantial preference for foreign rather than home investment. Quantitatively we know that such operations are of considerable magnitude, and growing sharply every year.

Analysis of Arguments Advanced for Continuing Preferential Treatment in the Taxation of Foreign Investment as Compared with Domestic Investment

Justification for continuing United States preferential tax treatment of income from foreign as compared with home investment has been based essentially on two arguments: (1) to tax U. S. subsidiaries abroad at full U. S. rates as income is earned will deter foreign investment, which will in turn, it is claimed, (a) dampen growth in employment and income in this country by reducing exports to subsidiaries which would have been established or expanded with the deterred investment funds, and (b) worsen rather than improve our balance of payments position because net inflows from direct foreign investments tend to exceed net outflows; (2) Equality in taxation as between firms in this country and U. S. subsidiaries abroad will put the subsidiaries abroad at a competitive disadvantage vis-a-vis foreign firms. Almost all of the economic arguments advanced against the Treasury proposals are related to, and indeed hinge upon the validity of these basic contentions. Let us consider each matter in turn.

1. Possible adverse effects from deterring tax-induced foreign investment

The primary economic impact of removing tax deferral centers upon the possible effect on the outflow of new direct investment capital to manufacturing subsidiaries from the United States and on related inflows from dividend receipts and sale of exports generated by the foreign investment. It is generally agreed that the proposal will probably not affect the activities of petroleum companies. Most of the activities of the latter are carried on through branches rather than through foreign subsidiaries, and there is no deferral of taxes on branch profits. Further, foreign taxes paid by petroleum companies are generally more than 52 percent of income so that no U.S. tax liability arises.

In the hearings before the House Ways and Means Committee in the spring of 1961, the question of the effect of removing deferral was illustrated over and over again by reference to the experience of individual companies. Typically the new capital outflow reported as coming from the United States, usually year by year over some period of time, was compared with dividend income and with receipts from exports sold to or through foreign subsidiaries. "Inflows" so computed generally exceeds "outflows" by a substantial amount, and this has left the impression that the stimulus given foreign investment by tax deferral clearly contributes positively both to our employment situation because of the large export sales generated, and to our balance of payments position because total inflows exceeded outflows. There are five things wrong with this type of evidence.

First, the behavior of one company, or even a selected group of companies, may not be typical; net inflows of one may be more than offset by net outflows of others. Second, the data on capital outflow as reported by individual companies often include only purchases of stock in foreign subsidiaries; but a very large amount of the new capital outflow to Europe and Canada as reported in Commerce Department data consists of net increases in inter-company accounts, i.e. short-term credits for working capital which are not repaid. 1/ Third, even if all the measurable inflows and outflows are correctly included in such data (and many company studies ignore sales by subsidiaries made directly to the United States--an import payment which may be an important offset to export receipts), one important flow is inevitably excluded because it cannot be readily measured--that is, foreign subsidiary sales abroad which displace actual or potential U.S. exports. Fourth, the illustrations are almost invariably on a world-wide basis, whereas the Treasury proposal affects only income earned in developed countries. But as we shall see, there is a remarkable difference between the value of exports generated by a dollar of investment in other advanced industrial countries, and the value of exports generated by a dollar of investment in less developed countries.

1/ Capital outflow of this type comprised over half the total to Canada and Western Europe for 1961.

These four limitations to the approach which has been typically employed to support tax deferral are serious enough, but it is a fifth limitation which is crucial. The two types of flows being compared--the outflow of new capital and the dividend and export receipts for a given year, or five-year period, or ten-year period--are, in good part, not related one to another. The dividends, and most of the export receipts, of one year or period, have been generated by investment over many years prior to the current year or period; that portion of the inflows which has been generated by past investment, then, has nothing whatsoever to do with the outflow of the current year or period in question. To illustrate, suppose a corporation at the end of 1951 had $100 million of outstanding investment overseas, and was returning annually $20 million to this country in the form of dividends and payment for exports, royalties, fees, etc. Between 1952 and 1960, $50 million more in new capital goes out from this country (an amount which must include net changes in inter-company accounts), and annual inflows rise to $25 million. It is surely meaningless to say that the outflow of $50 million between 1952 and 1960 brought back $225 million ($25 million for each of 9 years) in inflows. Even to compare the $5 million increase in annual inflows with the $50 million outflow is misleading, since the former was generated in part by reinvested earnings from returns on the investment outstanding in 1951.

Because opinions have been so sharply divided over this issue, the Treasury Department recently undertook extensive re-study of the data in full consultation with interested business groups. We believe that the new investigation yields good measures for the major direct effects stemming from the outflow of direct investment funds, and serves to put the central issues involved in the tax deferral question in proper perspective.

A. Elimination of tax-induced foreign investment and the effect on income and employment

If elimination of tax deferral, or restrictions on the tax status of "tax haven" income, deters some new foreign investment, this will affect the export of some goods and services from the United States and the import of some goods and services into this country. This in turn may affect the current production of home substitutes for these imports. It is, however, a most difficult task to measure the full effects on current output--on income and employment--of new foreign investment, and thus to compare what would happen if the deterred foreign investment takes place with what would happen if it does not take place.

What we need are figures for all of the exports from and imports to the United States which are directly attributable to the existence of foreign subsidiaries, i.e. which would not have existed had the subsidiary not existed. More specifically, what we would like would be data on all of the following:

1. Any increase in American exports in a given year or average of years due to:

(a) The purchase of new United States plant and machinery because of reinvestment of earnings overseas and/or new direct investment from this country;

(b) The purchase of raw materials and intermediate products from the United States by newly created or expanded foreign subsidiaries of United States firms which would not have been sold by United States producers, for example to foreign firms, had the United States subsidiary not been in existence;

(c) The sale of finished goods exports from the United States through newly created subsidiaries which would not have been made through other channels had the subsidiary not been established;

(d) The sale of exports in general (i.e. not to subsidiaries) which arises from a stimulus to growth in income or in productive capacity, or from creating pressure on existing capacity, which is directly attributable to United States investment abroad;

(e) The sale of exports generated by "intangibles" associated with foreign investment--new contacts, the creation of an "international psychology" on the part of American businessmen, etc.

Less

2. The increase in United States imports from the newly created foreign subsidiaries which is additional to imports which would have entered the American market anyway, e.g., from foreign competitors of the subsidiary;

and less

3. The reduction in United States exports to the country where the subsidiary is located or to anywhere else in the world because of production and sale by the newly created foreign subsidiary.

All of these elements, which should enter into the "net export factor" in computing the effect on current production of new foreign investment may be thought of as continuing phenomena, with the exception perhaps of (1)(a). The purchase of new United States plant and equipment by United States subsidiaries should probably be

considered a once-and-for-all phenomenon, and therefore be subtracted from the initial outflow of investment funds in our computations rather than added as a (continuing) export receipt, although the argument can be made that a sufficiently large proportion of such exports is for replacement that it is just as well to consider them as an integral part of the regular export bundle.

So much for what we would like to have. What we actually have is the information provided by the 1961 survey by the Department of Commerce of 155 manufacturing corporations comprising 80 percent of all United States manufacturing investments abroad, information which is summarized in Table 4. These data are not as complete as we would like. 1/ And they contain some items that we do not want but cannot separate out. 2/ The qualifications work in both directions, however, i.e. in some situations they understate export receipts, for example, while in other situations they overstate export receipts. In general, the data are sound, and they do provide a foundation for analysis.

1/ We are told, for example, that they do not pick up all of the trade of subsidiaries with the United States because reports were made by the parent company and some subsidiaries both buy and sell in the United States independently of the parent. Since we subtract United States imports from subsidiaries from United States exports to subsidiaries, however, it would seem that such trade might tend to cancel out.

2/ Specifically, we are faced with the following principal limitations. First, the data do not adequately separate capital goods exports from other types of exports; we are forced into considering the former as continuing phenomena in spite of the fact that the very rapid but uneven growth of new investment in Western Europe in particular would suggest treating at least a good part of such exports separately from the main stream of goods moving there. Second, the data include all goods exported to subsidiaries; and there is no separation of raw materials and intermediate products on the one hand from finished goods on the other. Thus, there is absolutely no way, on the basis of Commerce data, even to enter a rough estimate of the volume included which might have been exported even if the subsidiaries had not existed. If a manufacturing subsidiary exists, finished goods exports will often be channeled through it, but a large portion of such sales might have been made without such a subsidiary. (It should be noted that some people have stated that a manufacturing subsidiary, not simply a sales and/or distribution outlet, is almost essential for such sales. There would surely be some validity for this position with respect to packaging and the like, but how far back in the production process one has to go to sell the finished goods would appear to be a debatable point.)

(footnote continued on page 11)

Table 4

Exports from the United States to, and Imports to the United States from Subsidiaries Abroad, 1959-1960 (by Region) (Survey of 155 Manufacturing Companies) 1/

(in millions of dollars)

	1959	1960	Average 1959-1960
Canada			
Manufacturing subsidiaries investment	4,467		
Exports from U.S. to subsidiaries	736 x 1.25 = 920 2/	732 x 1.25 = 915 2/	918
Exports on commission basis	13	14	
Gross exports	749 x 1.25 = 936	746 x 1.25 = 933	934
Ratio of gross exports to investment			20.9%
Less imports to U.S. from subsidiaries	112 x 1.25 = 140	117 x 1.25 = 146	142
Net exports	637 x 1.25 = 796	629 x 1.25 = 787	792
Ratio of net exports to investment			17.7%
Europe			
Manufacturing subsidiaries investment	2,880		
Exports from U.S. to subsidiaries	174 x 1.25 = 218 2/	265 x 1.25 = 331 2/	275
Exports on commission basis	21	26	
Gross exports	195 x 1.25 = 244	291 x 1.25 = 364	304
Ratio of gross exports to investment			10.6%
Less imports from subsidiaries	208 x 1.25 = 260	90 x 1.25 = 113	186
Net exports	-13 x 1.25 = -16	201 x 1.25 = 251	118
Ratio of net exports to investment			4.1%
Latin America			
Manufacturing subsidiaries investment	1,323		
Exports from U.S. to subsidiaries	301 x 1.25 = 376	334 x 1.25 = 418	397
Exports on commission basis	94	100	
Gross exports	395 x 1.25 = 494	434 x 1.25 = 542	518
Ratio of gross exports to investment			42.0%
Less imports from subsidiaries	6 x 1.25 = 8	4 x 1.25 = 5	7
Net exports	389 x 1.25 = 486	430 x 1.25 = 537	511
Ratio of net exports to investment			41.5%
Rest of World			
Manufacturing subsidiaries investment	722		
Exports from U.S. to subsidiaries	217 x 1.25 = 271	293 x 1.25 = 366	319
Exports on commission basis	15	30	
Gross exports	232 x 1.25 = 290	323 x 1.25 = 404	347
Ratio of gross exports to investment			48.0%
Less imports from subsidiaries	2 x 1.25 = 2	2 x 1.25 = 3	2
Net exports	230 x 1.25 = 288	321 x 1.25 = 401	345
Ratio of net exports to investment			47.8%
World			
Manufacturing subsidiaries investment	9,285		
Exports from U.S. to subsidiaries	1,429 x 1.25 = 1,786	1,625 x 1.25 = 2,031	1,909
Exports on commission basis	143	170	
Gross exports	1,572 x 1.25 = 1,965	1,795 x 1.25 = 2,244	2,105
Ratio of gross exports to investment			22.7% 3/
Less imports from subsidiaries	328 x 1.25 = 410	213 x 1.25 = 266	338
Net exports	1,244 x 1.25 = 1,555	1,582 x 1.25 = 1,978	1,767
Ratio of net exports to investment			19.0% 3/
Europe and Canada			
Manufacturing subsidiaries investment	7,347		
Gross exports	1,180	1,297	1,238
Ratio of gross exports to investment			16.9% 4/
Net exports	780	1,038	910
Ratio of net exports to investment			12.4% 4/
Rest of World			
Manufacturing subsidiaries investment	1,954		
Gross exports	784	946	865
Ratio of gross exports to investment			44.5% 3/
Net exports	789	938	863
Ratio of net exports to investment			44.2% 3/

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For footnotes and sources, see following page.

Footnotes and sources for Table 4.

1/ All data in the table are multiplied by 1.25 because the Commerce Department sample is said to cover "at least 80 percent of all U.S. manufacturing investments abroad."

2/ Of which it is estimated that $21 million in 1959, and $54 million in 1960 were capital goods exports, the same approximate amount being sent to subsidiaries in Canada and to subsidiaries in Europe. The Commerce Department survey states:

> The manufacturing subsidiaries abroad reported imports of $129 million of capital equipment from the United States in 1960, compared with about half that much in 1959. Canada and Europe each accounted for about one-third of the 1960 total. A number of reporters were not able to segregate exports of capital equipment from other exports, so that the total for equipment is comparatively incomplete.

One-third of $129 million is $43 million, multiplied by 1.25 as per footnote 1/ yields $54 million, and a comparable calculation for a $65 million 1959 total yields $21 million.

3/ These are unweighted ratios, but the weighted ratios are little different. See footnote 4. The weighted net export ratio for the world as a whole on the basis of new capital outflow, 1957-1960, is 16.6 percent.

4/ These are unweighted ratios. Total outstanding investment in manufacturing in 1959 was about equally weighted as between Canada and Europe, but over 70 percent of the new capital outflow between 1957 and 1961 was to Europe, less than 30 percent to Canada. The weighted net export ratio to measure the effect of an average new dollar invested in developed countries is 8.0 percent.

Sources:
Data on exports and imports are from the survey of 155 manufacturing companies made by the U. S. Department of Commerce in 1961, the results being published in Hearings on the President's 1961 Tax Recommendations, Committee on Ways and Means of the House of Representatives, Volume 1, pages 427-31. Data on manufacturing subsidiary investment outstanding are from Table A1 in the appendix to this exhibit.

The evidence accumulated in Table 4 can be interpreted in either of two ways, depending upon our assumptions about the nature of capital goods exports. We can assume that capital goods exports to subsidiaries are a once-and-for-all phenomenon, associated with new capital outflow; or we can assume that these capital goods exports are largely for replacement purposes and can therefore be interpreted as a continuous stream once investment has taken place, much like raw material and other exports. The two interpretations lead to similar results as it turns out, but it may be useful to delineate both so that there will be no confusion.

Consider Europe first, the main area which might be affected by elimination of tax deferral and by tax haven legislation. If we think

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2/ (continued from page 10)
A third limitation of the data has to do with items 1.(d). and 1.(e). Presumably item 1.(d) is small since United States investment is a small proportion of total investment, especially in Western Europe. It has been suggested, however, that the fact that European production has been close to capacity in recent years could have meant that the addition of new U. S. investment funds created a substantial increase in exports from the United States, not directly related to the operations of U. S. subsidiaries, simply because Europe did not at the time have the needed capacity to meet the additional demand for equipment and supplies. Some businessmen feel, furthermore, that the data, which include all exports made to subsidiaries on a commission basis (and thus presumably include some "contact sales"), substantially understate item 1.(e). Management becomes more "internationally minded" with existence of manufacturing subsidiaries, and this leads to more thought about exports, more interest in the promotion of exports, and so forth. However, one weights this factor, it is clearly one which cannot be expressed rigorously in quantitative terms.

When we come to the negative items which must be subtracted from "gross exports," we suggest first of all that 2. may be overstated in the data to the extent that subsidiaries' sales in the United States simply replace imports from foreign competitors which would have been purchased had there been no subsidiary. This is a counterpart to that considered with respect to export items 1.(b) and 1.(c) above. On the other hand, item 3. does not appear in the data at all, and there are good reasons for believing that this item might be very large indeed, as suggested in the text.

of capital goods exports as a once-and-for-all phenomenon, we can reason as follows. Total capital outflow to manufacturing subsidiaries in Europe for the two years 1959-60 was $838 million (see Appendix Table A1). Capital equipment exports to manufacturing subsidiaries in Europe over those two years amounted to approximately $75 million. A dollar of new investment generated, therefore, something less than 10 cents worth of capital goods exports, on a once-and-for-all basis. Subtracting the $75 million from the two-year gross export total of $608 million, we obtain a figure of $533 million for the two year period, or a figure of $267 million as an annual average. These are the continuing exports of raw materials, intermediate products, and finished goods sold to or through manufacturing subsidiaries in Europe-exports which must be related to the <u>total outstanding</u> plant and equipment existing in Europe at this time. Dividing $267 million by the $2,880 million of outstanding investment in 1959 yields approximately 9 cents worth of continuing gross exports. We can say that a new dollar from the United States, or a dollar of European earnings which is reinvested, will yield 9 cents worth of <u>continuing</u> exports of raw materials, intermediate products, and finished goods sold to or through manufacturing subsidiaries in Europe. But investment in Europe also means new sales by subsidiaries to the United States, much of which probably displaces American production and all of which implies an additional import payment in balance of payments terms. Dividing the annual average $186 million of imports by $2,880 million implies that a dollar invested in Europe generates 6 cents worth of imports from subsidiaries into this country. In summary, treating capital goods exports on a once-and-for-all basis we reach the conclusion that a dollar invested in Europe yields something less than 10 cents worth of capital goods exports in the first year, and a continuing stream of "net exports" thereafter of 3 cents a year. 1/

This approach to the problem, as a first approximation, implies that the <u>immediate employment effect</u> in the United States of a dollar invested in Europe might be at most approximately 10 cents. A dollar invested at home has ten times the immediate employment effect of a dollar invested in Europe. Or in other words, if a dollar which

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1/ It should be noted that there is a marked distinction between the year 1959 and the year 1960 in the data for Europe. The 1959 data imply a <u>negative</u> "net export" factor, whereas the 1960 data imply a ratio of nearly 7 percent. Our general conclusions would seem to be little affected, however, even if we chose to use the 1960 data alone, rather than averaging the two years.

is induced to go to Europe by special tax privileges is deterred from going there by removal of those privileges, and anything more than 10 cents of that dollar is then invested at home, there should be a favorable short-run effect on income and employment in this country.

Before discussing possible long-run growth and employment effects of elimination of tax deferral, let us consider the second approach to the question of capital goods exports--treating them as part of the continuing stream of exports on the ground that many such exports are to replace existing equipment in European plants rather than designed to go into new plant financed by new capital outflow from this country. Here we would simply divide the total annual average gross exports of $304 million by $2,880 million, obtaining 10.6 percent; or subtracting for European subsidiaries' sales in this country, we would obtain a "net export" ratio of 4 percent, rather than the 3 percent found under our first assumption. We can say that a new dollar of capital outflow from the United States, or a dollar of European earnings which is reinvested, will yield 10 cents worth of continuing exports from the United States, of goods of all kinds, and 6 cents worth of continuing imports into the United States. Noting the above possible qualification with respect to immediate employment effects, it seems best to use this second approach for work which follows, for a number of reasons: (1) many capital goods exports are surely for replacement purposes, that is, there is a steady stream; (2) the figures for capital goods exports are only rough estimates as noted in footnote 2/ to Table 4; (3) the two approaches clearly yield very similar results; and (4) the second is far simpler than the first.

It should be noted that the "net export" factor of 4 cents which we arrive at does not include related exports--exports which are not sold to or through subsidiaries even on a commission basis but may nevertheless be dependent in one way or another on the operation of subsidiaries abroad. Nor does it include displaced exports--exports from the United States either to the European country where the subsidiary is located or sales to third-country markets which may be displaced by sales of the U. S. foreign subsidiary. The "related exports" which were claimed in one private study of 19 major manufacturing companies, on the basis of world-wide data, amounted approximately to one-half of the total gross exports sold to or through foreign subsidiaries. 1/ This would imply a figure of $150 million so far as Europe was concerned, which might be thought of as an upper limit for any estimate of "related exports." So far as the displacement

1/ See the Heinz study in House Ways and Means Committee, Hearings on the President's Tax Program, 1961, 3185-3209.

effect is concerned, total sales of U. S. manufacturing subsidiaries in Europe amounted to $9,310 million in 1960 with approximately one-sixth of such sales comprising exports to countries other than the United States. 1/ Thus, we can say the following. If only a little over one percent of the total sales of American-owned subsidiaries in Europe serve to displace sales from the United States, or if 8 percent of estimated sales by these subsidiaries made outside the country in which they are located displace sales from the United States, the direct "net export" impact on the United States of foreign investment in Europe would be wiped out entirely, i.e. the $118 million shown in Table 4 would be completely offset. If only 1.5 percent of total sales, or 9 percent of export sales other than to the United States, served to displace U. S. exports, the hypothetical "related export" factor of $150 million would be offset by the "displacement factor." And if these percentages on displacement were as high as 3 percent and/or 17 percent, both the possible "related exports" and the "net exports" going directly to and through subsidiaries would be offset by export displacement.

We have already considered the immediate employment effects in the United States of investment in Europe, under the most favorable possible assumptions, and determined that elimination of tax deferral should lead to increased employment in this country. Removal of the tax incentives to invest in Europe should also have a favorable long-run effect on economic growth in this country. The dollar which is induced to go to Europe for these reasons expands plant capacity there, which leads to a continuing 4 cents worth of "net exports" from this country, assuming that demand keeps up with capacity. A dollar invested in this country in new plant and equipment is normally thought to create a continuing stream of 40 cents worth of current output, if demand keeps up with capacity. Thus, if anything more than 10 cents of the dollar that is deterred from going to Europe by elimination of deferral is invested at home, there will be a favorable long-run effect on income and employment in this country.

1/ See Survey of Current Business, September 1961, p. 23, for 1960 sales. No information is available on sales made outside the country of location in this year, but Department of Commerce data for 1957 show that over one-sixth of total sales in that year were exports to countries other than the United States. See U. S. Department of Commerce, U. S. Business Investments in Foreign Countries (1960), Table 22, p. 110.

When investment in Canada is added to investment in Europe, we get a slightly more favorable picture of the effect of new foreign investment on exports. Between 1957 and 1960, 71 percent of the new capital outflow to these two regions went to Europe, 29 percent to Canada, and this ratio was even more pronounced in the direction of Europe in 1961, according to preliminary data. Assuming, then, that any deterred investment consequent upon elimination of tax deferral is distributed in these proportions as between Canada and Western Europe, it turns out that elimination of a dollar of tax-induced new investment in these developed regions means elimination of 8 cents worth, rather than 4 cents worth, of "net exports." 1/

So much for developed regions. We get a very different picture when we look at the relationship between (a) direct investment in manufacturing subsidiaries located in Latin America and in other less developed regions of the world, and (b) exports to these subsidiaries minus imports from them. If we eliminated tax deferral and this step deterred a dollar of new investment in these regions, it would, according to the data in Table 4, eliminate over 40 cents worth of exports from the United States. The nature of manufacturing investment in these regions is radically different from that in advanced industrial countries. Obviously alternative sources of supply are much more limited, and subsidiaries are necessarily thrown much more back on the American market, both for capital equipment and for raw materials and intermediate parts.

1/ The "net export" ratio for Canada alone is 17.7 percent, but weighting this by 29 percent and the European ratio by 71 percent yields 8.0 percent. Of course, all of these ratios are based on the assumption that average ratios--total exports divided by total direct investment outstanding--correctly reflect incremental ratios, which is what we are really seeking to measure. There is no reason to expect that such would not be the case, and the differential could not under any circumstances be sufficiently significant to alter the basic conclusions.

®

B. Elimination of tax-induced foreign investment and the overall effect on our balance of payments

There has been much discussion, and considerable disagreement on the issue of the overall effect on our balance of payments of eliminating the special tax incentives now existing which favor investment in other developed countries as compared with investment at home. There are various ways of attempting to show this, but perhaps the best is to ask ourselves: "What has been the effect on our balance of payments of investment in manufacturing in Canada and Western Europe over the last few years, say from 1952 to 1960?" Presumably only a small proportion of new capital outflow over this period was actually tax-induced, but however large or small it should have had the same kind of general effect on the balance of payments as the total gross investment outflow to these regions. 1/

To answer this question, we must add to net export receipts generated by new capital outflow and reinvested earnings other inflows generated in the same fashion, namely, income from management fees and patent and copyright royalties, as well as dividend income. Again we stress that the inflows we add together must be those which are related to the capital outflow over this period, 1952 to 1960, not those related to investment prior to this period, nor to the reinvested earnings of plants already existing in 1951. To compare total inflows with total outflows, even over a nine-year period, as many individual company statements have done, tells us nothing about the magnitude of the inflows generated by the new investment outflow over the period, since a substantial portion of such inflows were actually the result of investment prior to the period.

In Chart 1, based on the data in Tables A1-A5 in the appendix to this Exhibit, we show the cumulative amount of capital outflow to Canada and Western Europe over the period 1952 to 1960, and the cumulative amount of dividend inflows, receipts from fees and royalties, and net export receipts estimated to have been generated (a) by the new investment and (b) by the reinvestment of earnings over the period which were made on this new investment.

1/Actually, if investment was really induced by tax advantages, and would not have been made without this inducement, it would imply that the rate of return was below the average. This would mean that the net balance of payments effect of such investment was less favorable or more unfavorable than that derived from aggregate data on total investment.

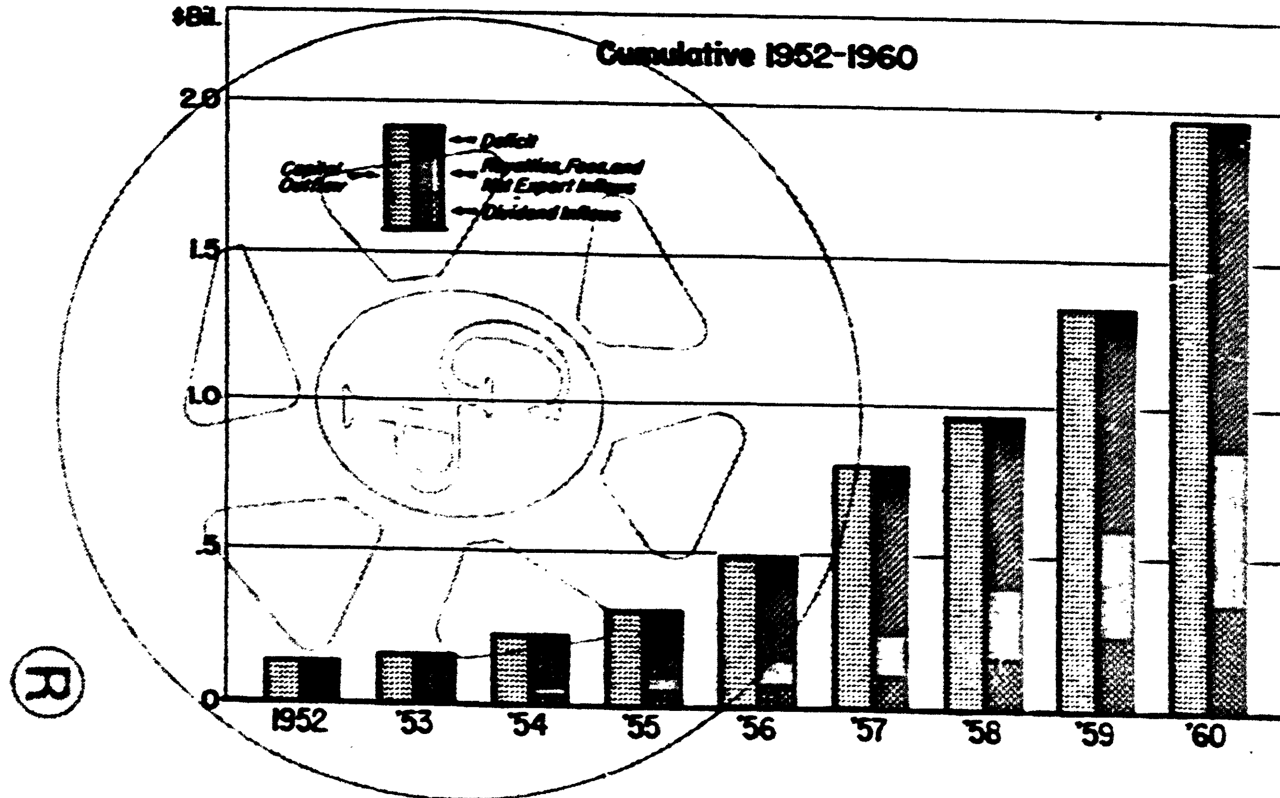
Chart 1
EFFECT OF CAPITAL OUTFLOW TO MANUFACTURING SUBSIDIARIES IN CANADA AND W. EUROPE
$Bil.
Cumulative 1952-1960
2.0
1.5
1.0
.5
0
Deficit
Capital Outflow
Dividend Inflows
1952
'53
'54
'55
'56
'57
'58
'59
'60

It is clear from Chart 1 that the cumulative deficit generated by new direct investment in other developed countries grew in every year after 1953, i.e. that every year the new capital outflow exceeded the inflows generated by the growth in investment outstanding subsequent to the year 1952. We hasten to add immediately that at some point this situation should right itself; the cumulative deficit should get smaller and eventually disappear unless new investment continues to grow at an ever-increasing rate as it has been doing in recent years, and this hardly seems likely. But clearly the "catching up" period is a long one indeed if the capital outflow keeps growing, even at a steady rate. If the outflow from 1963 forward grows at a steady 10 percent a year, which has been the average over the last eight years, there would be no net improvement in our balance of payments until 1975, i.e. inflows would not catch up to outflows on a cumulative basis until 1975. Even if the growth rate drops to 5 percent a year it will still be the early 1970's before the capital outflow over this period, to developed countries, ceases to add to our balance of payments difficulties and begins to make a positive contribution.

Put another way, the evidence indicates that the elimination of any investment which may now be going to other developed countries primarily because of the tax inducements provided by the existence of the deferral privilege and/or tax haven opportunities, would contribute favorably to our overall balance of payments position over at least the next 10 to 12 years, and probably over a longer period. Because of the difference with respect to the generation of exports already discussed, on the other hand, deterring investment in less developed countries by altering present tax incentives would improve our balance of payments position over a very much shorter period. Here cumulative inflows would be expected to catch up to cumulative outflows in three to four years.

2. <u>Elimination of tax deferral will stimulate the remission of a larger proportion of earnings to the United States</u>

The possible "deterrent effect" on new tax-induced foreign investment as a consequence of removing existing tax preferences with respect to investment in developed countries is an economic issue which has been widely discussed. Less often analyzed, but perhaps more important from the point of view of our overall balance of payments position, is the "switch effect" which may be expected to follow from the elimination of tax deferral and from the tax haven legislation--the possibility that with removal of the special incentives to keep earnings abroad, a larger amount may be sent home, both as dividends and in order to pay the taxes due.

At present, the proportion of earnings which are remitted as dividends from subsidiaries in Canada and Western Europe is substantially below that which prevails for domestic corporations in the United States. Forty-five percent of earnings after foreign taxes, or somewhat less than this after payment of the U.S. tax on distributed earnings as well (if the foreign tax rate is below the U.S. rate) is paid in dividends on foreign manufacturing operations, whereas the proportion for domestic manufacturing corporations is 53 percent. With a foreign tax rate of 40 percent, the typical situation at present would be as shown in the left-hand column of Table 5. If the tax advantage to leaving earnings abroad were removed, we would expect the situation to approximate more nearly the domestic situation, as shown in the right-hand column of Table 5. This might not occur immediately, of course, and if the rate of return on investment after taxes were higher abroad than in this country, the proportion of earnings after all taxes paid as a dividend might be somewhat less than 53 percent. But in general there should surely be some "switch effect"--an effect which would be stronger the lower the foreign tax rate and thus the greater the tax incentive now to leave earnings abroad.

Table 5

The Effect of Eliminating Tax Deferral on Remission of Income to the United States

	Existing situation	After elimination of deferral
1. Income	$100	$100
2. Less foreign tax a/	40	40
3. Income after foreign tax	$ 60	$ 60
4. U.S. tax on income as earned	-	12
5. Amount remitted as dividend to parent	24 b/	25 c/
6. U.S. tax	3 d/	
7. Total income remitted (dividend plus U.S. tax)	27 e/	37

a/Assumed foreign tax rate: 40 percent.
b/Forty-two percent of income after foreign tax.
c/Fifty-three percent of income after all taxes, which is the average for domestic manufacturing corporations in the United States.
d/Twelve percent of total income remitted (line 7).
e/Forty-five percent of income after foreign taxes. See Table A3 in the appendix to Exhibit III.

In Chart 2, supported by data in Tables A-6 and A-7 in the appendix, we combine the "switch effect" under the above assumptions with the "deterrent effect" in accordance with the general assumptions treated in the previous section in an effort to gain at least some general picture of what the total effect on our balance of payments might be as a result of full acceptance of the proposal to eliminate tax deferral with respect to the taxation of foreign corporate income in developed countries.

With a steady growth in capital outflow of 10 percent a year, income remitted to this country will be higher than at present, and this differential will get steadily larger, in spite of the fact that less earnings will be reinvested and thus the overall growth rate of our outstanding direct investment in developed countries will be reduced. On the other hand, the slower growth rate should gradually reduce our earnings from fees and royalties and "net exports," assuming that this factor is not completely offset by the displacement of U.S. domestic sales in foreign markets as a result of sales by foreign subsidiaries. But even if net exports, fees, and royalties are positive, it will take a long time for these losses to catch up to the gain in income remittances; the cumulative "switch effect" will be favorable at least until 1978 on our assumptions.

Below the line in Chart 2 we measure the gains and related losses from the "deterrent effect," and it is seen that this, too, will have a favorable effect on our balance of payments, until 1975 at any rate on our conservative assumption that there is no displacement factor, or that it just offsets any "related export" factor, as discussed in the previous section.

It is clear that subsidizing foreign investment through tax deferral <u>may</u> contribute positively to our balance of payments liquidity position in the very long run, but it will clearly worsen our balance of payments liquidity position over at least the next 10 to 15 years.

But if our actions are to turn on this issue, two last points are relevant. We are not mercantilists. We do not want a chronic surplus in our balance of payments. We want an increase in inflows now as compared with outflows because we have a deficit. But balance of payments liquidity problems come and go, governed to a large extent by the behavior of relative prices here and abroad. We may still be in difficulty in the early and middle 1970's. Surely we hope that this will not be the case, however; we hope that we can keep our prices under better control than prices elsewhere in the world in the immediate years ahead, and so get out of our present difficulties.

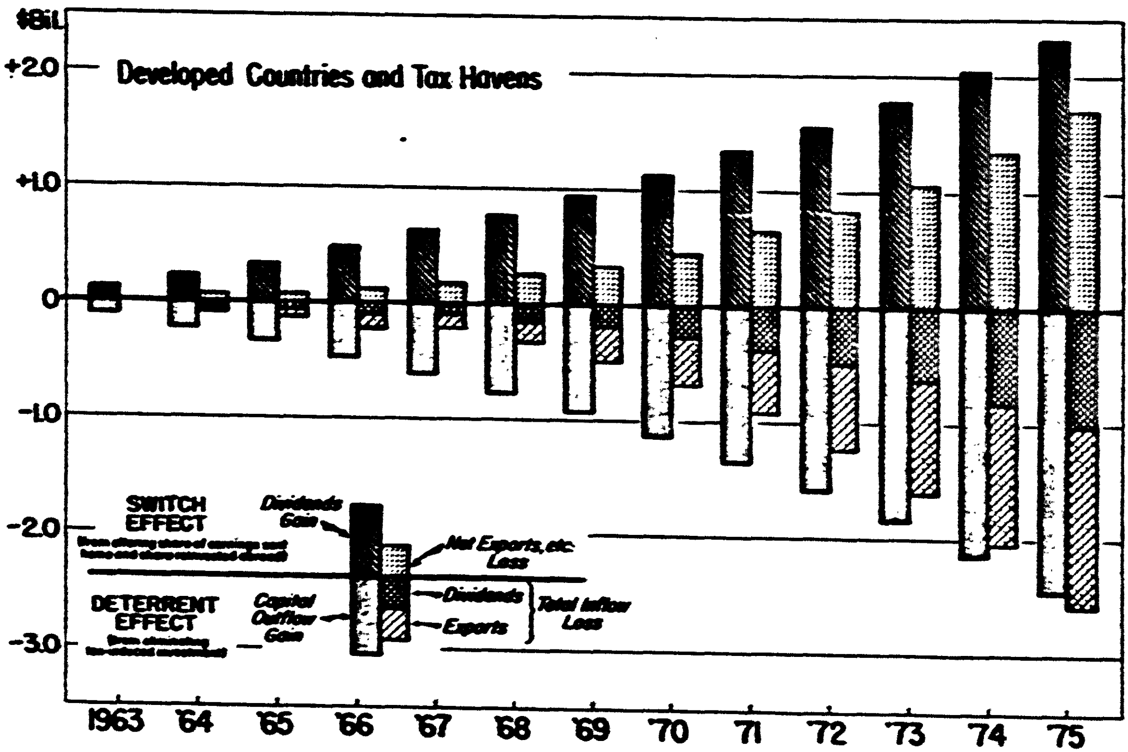
Chart 2
ESTIMATION OF CUMULATIVE BALANCE OF PAYMENTS
EFFECT OF ELIMINATING TAX DEFERRAL
$Bil.
+2.0
+1.0
0
-1.0
-2.0
-3.0
Developed Countries and Tax Havens
SWITCH EFFECT
DETERRENT EFFECT
Dividends Gain
Net Exports, etc. Loss
Capital Outflow Gain
Dividends
Exports
Total Inflow Loss
1963
'64
'65
'66
'67
'68
'69
'70
'71
'72
'73
'74
'75

The true long-run value of sacrificing goods and services now in order to invest abroad turns, then, on the real benefits to be derived from doing so, not on the monetary benefits. But the real benefits turn on the relationship of capital outflows to dividend inflows alone. When we receive dividends from our investments we, as a nation, can consume more. Export receipts generated by our investment improve our liquidity position but in real terms they simply mean that we are giving up some goods in order to obtain other goods, or in order to obtain gold. As we have seen, however, it will be a long, long time before dividend inflows alone catch up to our ever-increasing capital outflow.

What we really wish to do, then, is to improve our liquidity position in the immediate years ahead so as to eliminate our present "chronic" deficit, and to think thereafter of benefiting in real terms, both from our foreign trade and from our foreign investments. Eliminating deferral, in addition to being sound from the point of view of allocating our resources efficiently and from the point of view of stimulating income and employment in this country, supports both our short-run and our long-run balance of payments objective.

3. Taxation and foreign competition

Much has been made of the argument that the elimination of tax deferral will put U. S. subsidiaries abroad at a competitive disadvantage vis-a-vis foreign competitors, in particular in third-country markets. In considering this contention, it is important to maintain perspective, to analyze carefully what "being at a competitive disadvantage" is likely to mean.

First, consider two extraneous issues, but issues which have nevertheless been raised over and over again. It is argued that some countries have turnover and other types of indirect taxes, and that elimination of tax deferral may therefore mean total taxes in excess of 52 percent. But such taxes are not the same as income taxes. Like excise taxes in the United States they are passed on to the consumer in the form of higher prices since they add to operating costs. They are not borne out of corporate profits, and they are charged to foreign competitors as well as to American subsidiaries operating abroad. In short, the existence of such taxes is not relevant to the issue of tax deferral and the competitive position of American foreign subsidiaries. A second argument frequently heard is that foreign companies are not restricted in third-country markets, are free to use tax haven operations, and so forth, so that U. S. firms will be at a competitive disadvantage in this respect. But companies in most European countries are subject to direct controls

of one kind or another, to limit evasion of taxes, to restrict foreign investment which will be harmful to the balance of payments--the latter true of the United Kingdom especially (where stated government policy currently is to restrict new foreign investment unless the pay-back period is two years), and to control remission of dividends and reinvestment of earnings.

Turning to relevant issues with respect to the effect of eliminating tax deferral on the competitive position of U. S. subsidiaries in Europe, what it may in fact mean depends upon how each particular firm reacts to the change. In some cases, the parent firm in the United States may choose to pay any additional taxes due, in which case there will be no effect on the foreign subsidiary's competitive position at all. In other cases, payment of the tax by the subsidiary may simply limit investment in new activities, completely unrelated to its existing activities, or even from lending money to the parent company in the United States -- again not affecting its competitive position at all.

But suppose none of these situations exists, and that elimination of tax deferral reduces retained earnings and reduces expansion in existing activities. Then there are still two possibilities. If, following elimination of deferral, the rate of return after all taxes is greater for the subsidiary than for its foreign competitor, there is no real problem. The subsidiary will presumably continue to grow relative to its competitor if they pay the same dividends to stockholders. The subsidiary in this case has substantial real cost advantages over its competitor--enough to outweigh the disadvantage of having to pay a higher corporate income tax if U. S. rates are higher than those applied to its competitor.

If, on the other hand, after elimination of tax deferral, the foreign subsidiary's rate of return after all taxes is now less than its foreign competitor, the subsidiary may slowly experience a decline in its market share. Faced with this situation, the foreign subsidiary could maintain the level of retained earnings overseas, and thus retain its market share, if it wished to, in one of two ways: (a) reduce the level of dividends paid to stockholders; (b) borrow funds, from the parent company or elsewhere, equal to the interest-free loan it had been getting as a result of tax deferral--the approximate short-run cost of remaining fully competitive would be the interest charge on borrowings equal to the new taxes which would have to be paid.

Whether or not the foreign subsidiary wished to pursue one of these two courses and maintain its share of the foreign market would, in the last analysis, depend upon the relative profitability of

alternative investment opportunities--for example, in the United States. If the rate of return abroad over a number of years proved to be greater than the rate of return at home when the tax on both incomes was the same, it would maintain and expand its position abroad relative to its position at home. If this were not the case, it would do the reverse.

And so we inevitably come back again to the principle of neutrality in taxation. A subsidiary abroad will be put at a competitive disadvantage only in the sense that elimination of deferral may reduce its retained earnings and thus limit its overseas growth. It will allow this to happen only if the incentive to invest abroad is in fact based, at least in part, on tax considerations. And it is precisely this type of artificial inducement which is inequitable, which leads to misallocation of our own and world resources, which has an adverse effect on employment, income, and growth in this country, and which will, if allowed to continue, damage our balance of payments position in the critical years ahead.

EXHIBIT III

GENERAL STATISTICAL APPENDIX

Note on Sources

All of the data used in the tables in the appendix and in the text are from published information of the U.S. Department of Commerce unless otherwise noted. The basic information on direct investments in Table A1 is derived from annual surveys on foreign investments, published in the Survey of Current Business each year; using always the latest revised data available.

Table A1
United States Direct Investment Outstanding and Outflows and Inflows by Area and Selected Industries, 1953-1960
(Millions of dollars)

	1952 Total (Revised)	1953 Total (Revised)	1953 Petroleum (Revised)	1953 Manufacturing (Revised)	1954 Total (Revised)	1954 Petroleum (Revised)	1954 Manufacturing (Revised)
CANADA							
Investment Outstanding	4,593 1/	5,242	933	2,418	5,871	1,152	2,592
Capital outflow	420	387	181	27	385	190	51
Reinvested earnings	199	259	36	153	232	25	123
Income	222	208	-20	132	237	-10	138
Earnings	421	467	16	274	470	15	249
Royalties & fees	----	----	2/	----	----	----	----
WESTERN EUROPE							
Investment Outstanding	2,145 3/	2,369	609	1,295	2,639	668	1,451
Capital outflow	-8	51	33	-7	50	20	21
Reinvested earnings	174	173	45	115	198	36	134
Income	129	143	30	75	186	32	106
Earnings	303	316	76	193	384	68	239
Royalties & fees	----	----	2/	----	----	----	----
LATIN AMERICAN REPUBLICS							
Investment Outstanding	5,758 4/	6,034	1,684	1,149	6,244	1,689	1,240
Capital outflow	277	117	58	-73	88	-22	24
Reinvested earnings	303	152	51	54	125	29	69
Income	599	570	356	68	589	351	56
Earnings	902	722	409	122	715	380	123
Royalties & fees	----	----	2/	----	----	----	----
REST OF THE WORLD							
Investment Outstanding	2,323 5/	2,684	1,709	364	2,872	1,761	428
Capital outflow	161	166	136	0	141	89	15
Reinvested earnings	200	192	106	39	89	4	50
Income	469	477	399	34	713	476	45
Earnings	669	669	502	78	800	501	87
Royalties & fees	----	----	2/	----	----	----	----
ALL AREAS							
Investment Outstanding	14,819 6/	16,329	4,935	5,226	17,626	5,270	5,711
Capital outflow	850	721	408	-53	664	277	111
Reinvested earnings	876	776	238	361	644	94	376
Income	1,419	1,398	765	309	1,725	849	345
Earnings	2,295	2,174	1,003	667	2,369	964	698
Royalties & fees	----	----	2/	----	----	----	----

EXHIBIT III

Table A1 (Continued)

	1955 Total (Revised)	1955 Petroleum (Prelim.)	1955 Manufacturing (Prelim.)	1956 Total (Revised)	1956 Petroleum (Prelim.)	1956 Manufacturing (Prelim.)
CANADA						
Investment Outstanding	6,494	1,350	2,841	7,460	1,768	3,196
Capital outflow	300	132	54	542	280	101
Reinvested earnings	298	40	158	367	48	237
Income	293	4	172	353	27	156
Earnings	591	44	330	720	75	393
Royalties & fees	----	----	2/	----	----	----
WESTERN EUROPE						
Investment Outstanding	3,004	764	1,640	3,520	992	1,861
Capital outflow	140	53	36	486	334	83
Reinvested earnings	219	40	144	204	63	111
Income	255	74	130	280	76	135
Earnings	474	114	274	483	139	246
Royalties & fees	----	----	2/	----	----	----
LATIN AMERICAN REPUBLICS						
Investment Outstanding	6,608	1,601	1,372	7,459	2,232	1,543
Capital outflow	193	49	60	592	365	76
Reinvested earnings	192	44	67	241	67	72
Income	678	438	52	800	530	53
Earnings	870	483	119	1,041	597	125
Royalties & fees	----	----	2/	----	----	----
REST OF THE WORLD						
Investment Outstanding	3,207	1,934	496	3,738	2,288	552
Capital outflow	146	86	10	239	150	8
Reinvested earnings	169	76	54	138	80	48
Income	686	523	44	687	515	46
Earnings	876	598	98	876	595	94
Royalties & fees	----	----	2/	----	----	----
ALL AREAS						
Investment Outstanding	19,313	5,849	6,349	22,177	7,280	7,152
Capital outflow	779	320	160	1,859	1,139	268
Reinvested earnings	898	200	423	1,000	258	468
Income	1,912	1,039	393	2,120	1,148	390
Earnings	2,811	1,239	821	3,120	1,406	858
Royalties & fees	----	----	2/	----	----	----

EXHIBIT III

Table A1 (Continued)

	1957 Total (Revised)	1957 Petroleum (Revised)	1957 Manufacturing (Revised)	1958 Total (Revised)	1958 Petroleum (Revised)	1958 Manufacturing (Revised)
CANADA						
Investment Outstanding	8,637	2,016	3,924	9,470	2,293	4,164
Capital outflow	718	250	184	421	237	72
Reinvested earnings	357	67	180	279	40	168
Income	335	56	171	315	27	188
Earnings	653	112	342	569	57	349
Royalties & fees	60	3	38	65	8	39
WESTERN EUROPE						
Investment Outstanding	4,151	1,253	2,195	4,573	1,320	2,475
Capital outflow	287	135	120	190	67	92
Reinvested earnings	294	95	154	238	8	180
Income	281	58	145	339	95	165
Earnings	582	152	306	582	103	349
Royalties & fees	58	5	45	82	13	59
LATIN AMERICAN REPUBLICS						
Investment Outstanding	7,434	2,702	1,270	7,751	2,825	1,316
Capital outflow	1,163	862	102	299	147	63
Reinvested earnings	239	64	67	143	13	58
Income	880	576	62	641	382	47
Earnings	1,096	638	129	760	393	104
Royalties & fees	70	17	21	66	14	21
REST OF THE WORLD						
Investment Outstanding	5,040	3,084	620	5,593	3,379	718
Capital outflow	675	161	26	271	198	42
Reinvested earnings	473	242	54	285	95	58
Income	753	586	51	845	685	60
Earnings	1,230	824	107	1,123	771	124
Royalties & fees	52	31	13	66	44	15
ALL AREAS						
Investment Outstanding	25,262	9,055	8,009	27,387	9,817	8,673
Capital outflow	2,482	1,408	432	1,181	649	269
Reinvested earnings	1,363	468	455	945	156	464
Income	2,249	1,276	429	2,140	1,189	460
Earnings	3,561	1,726	884	3,034	1,324	926
Royalties & fees	241	56	117	280	78	133

EXHIBIT III

Table A1 (Continued)

	1959 Total (Revised)	1959 Petroleum (Prelim.)	1959 Manufacturing (Prelim.)	1960 Total (Prelim.)	1960 Petroleum (Prelim.)	1960 Manufacturing (Prelim.)	1961 Total (Est.) 7/
CANADA							
Investment Outstanding	10,310	2,465	4,558	11,198	2,667	4,827	N.A.
Capital outflow	417	113	139	471	138	31	295
Reinvested earnings	393	44	240	389	46	234	N.A.
Income	345	41	206	368	60	176	328
Earnings	713	74	438	718	97	398	N.A.
Royalties & fees	78	10	46	74	10	43	N.A.
WESTERN EUROPE							
Investment Outstanding	5,323	1,453	2,927	6,645	1,726	3,797	N.A.
Capital outflow	484	148	231	962	273	607	604
Reinvested earnings	266	-7	207	326	1	237	N.A.
Income	393	125	226	427	85	241	495
Earnings	667	114	444	762	85	487	N.A.
Royalties & fees	105	20	72	113	15	80	N.A.
LATIN AMERICAN REPUBLICS							
Investment Outstanding	8,365	2,963	1,405	8,365	2,882	1,610	N.A.
Capital outflow	95	129	63	95	-7	125	257
Reinvested earnings	202	31	71	215	33	86	N.A.
Income	600	292	50	641	311	63	641
Earnings	774	321	120	829	345	146	N.A.
Royalties & fees	74	17	25	74	15	31	N.A.
REST OF THE WORLD							
Investment Outstanding	8,746	3,542	802	6,536	3,669	918	N.A.
Capital outflow	698	121	27	166	51	39	436
Reinvested earnings	228	41	56	324	77	70	N.A.
Income	868	642	67	919	687	70	937
Earnings	1,087	676	127	1,237	755	145	N.A.
Royalties & fees	68	43	15	84	47	17	N.A.
ALL AREAS							
Investment Outstanding	29,805	10,423	9,692	32,744	10,944	11,152	N.A.
Capital outflow	1,372	511	450	1,694	455	802	1,592
Reinvested earnings	1,039	109	574	1,254	157	627	N.A.
Income	2,206	1,100	549	2,348	1,143	550	2,101
Earnings	3,241	1,165	1,129	3,546	1,282	1,176	N.A.
Royalties & fees	25	90	158	344	87	171	N.A.

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TABLE A1

FOOTNOTES

1/ Of which $715 million in petroleum and $2,241 million in manufacturing.

2/ Reliable data for fees and royalties prior to 1957 are not available.

3/ Of which $532 million in petroleum and $1,187 million in manufacturing.

4/ Of which $1,577 million in petroleum and $1,166 million in manufacturing.

5/ Of which $1,467 million in petroleum and $326 million in manufacturing.

6/ Of which $4,291 million in petroleum and $4,920 million in manufacturing.

7/ Projections of data for first three quarters.

Source: Compiled from U. S. Department of Commerce data as explained in general note on sources.

EXHIBIT III

Table A2

The Rate of Return on U. S. Direct Investment Abroad, 1953 - 1960 (by region)

(millions of dollars)

	Earnings 1953-56	Investment 1952-55	Ratio %	Earnings 1957-60	Investment 1956-59	Ratio %	Earnings 1953-60	Investment 1952-59	Ratio %
Canada									
All industries	2,248	22,200	10.1	2,653	35,877	7.4	4,901	58,077	8.4
Petroleum	150	4,150	3.6	340	8,542	4.0	490	12,692	3.9
Manufacturing	1,246	10,092	12.3	1,527	15,842	9.6	2,773	25,934	10.7
Western Europe									
All industries	1,657	10,157	16.3	2,593	17,567	14.8	4,250	27,724	15.3
Petroleum	397	2,573	15.4	454	5,018	9.0	851	7,591	11.2
Manufacturing	952	5,573	17.1	1,586	9,458	16.8	2,538	15,031	16.9
Subtotal:									
Canada & Western Europe									
All industries	3,905	32,357	12.1	5,246	53,444	9.8	9,151	85,801	10.7
Petroleum	547	6,687	8.2	794	13,560	5.9	1,341	20,247	6.6
Manufacturing	2,198	15,665	14.0	3,113	25,300	12.3	5,311	40,965	13.0
Latin American Republics									
All industries	3,348	24,644	13.6	3,459	31,009	11.2	6,807	55,653	12.2
Petroleum	1,869	6,751	27.7	1,697	10,722	15.8	3,566	17,473	20.4
Manufacturing	489	4,927	9.9	499	5,534	9.0	988	10,461	9.4
Rest of the World									
All industries	3,221	11,086	29.1	4,677	23,117	20.2	7,898	34,203	23.[illegible]
Petroleum	2,196	6,871	32.0	3,026	12,293	24.6	5,222	19,164	27.2
Manufacturing	357	1,614	22.1	503	2,692	18.7	860	4,306	20.0
Subtotal:									
Latin America & Best of World									
All industries	6,569	35,730	18.4	8,136	54,126	15.0	14,705	89,856	16.4
Petroleum	4,065	13,622	29.8	4,723	23,015	20.5	8,788	36,637	24.0
Manufacturing	846	6,541	12.9	1,002	8,226	12.2	1,848	14,767	12.5

(concluded on next page)

EXHIBIT III

Table A2 (Continued)

	Earnings: 1953-56	Investment: 1952-55	Ratio: %	Earnings: 1957-60	Investment: 1956-59	Ratio: %	Earnings: 1953-60	Investment: 1952-59	Ratio: %
World									
All industries	10,474	68,087	15.4	13,382	107,570	12.4	23,856	175,657	13.6
Petroleum	4,612	20,345	22.7	5,517	36,575	15.1	10,129	56,920	17.8
Manufacturing	3,044	22,306	13.6	4,115	33,526	12.3	7,159	55,832	12.8

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Source: Compiled from figures for earnings, and direct investment outstanding, in Table A1.

EXHIBIT III

Table A3
Earnings on Common Stock, Common Dividends, and Ratio
of Dividends to Earnings
U. S. Subsidiaries Abroad, 1953 - 1960 (by region)
(Millions of dollars)

	1953	1954	1955	1956	1957	1958	1959	1960	1953-56	1957-60	1953-60
CANADA: All Industries											
Earnings on Common	513	487	608	691	608	576	704	606	2,293	2,592	5,083
Common Dividends	198	198	239	268	257	269	288	288	881	1,078	1,938
Ratio (%)									37.1	41.6	38.7
Petroleum											
Earnings	56	49	67	101	106	86	91	105	273	388	661
Dividends	17	21	22	29	37	39	40	50	89	166	255
Ratio (%)									32.6	42.7	38.6
Manufacturing											
Earnings	336	298	359	300	316	341	433	398	1,377	1,504	2,831
Dividends	133	120	133	107	148	148	180	148	513	636	1,149
Ratio (%)									37.3	42.3	39.9
WESTERN EUROPE: All Industries											
Earnings on Common	209	358	449	581	551	509	685	709	1,617	2,396	4,011
Common Dividends	111	150	218	261	245	281	341	348	740	1,218	1,958
Ratio (%)									45.8	50.6	48.7
Petroleum											
Earnings	76	72	120	133	163	79	76	87	400	405	825
Dividends	30	34	76	84	67	70	61	85	226	303	529
Ratio (%)									53.8	74.8	64.1
Manufacturing											
Earnings	178	236	262	307	297	338	437	476	983	1,548	2,511
Dividends	60	96	111	140	134	151	211	286	405	782	1,187
Ratio (%)									41.1	46.7	44.9
CANADA & EUROPE: All Industries (Subtotal)											
Earnings on Common	802	845	1,051	1,212	1,179	1,083	1,389	1,393	3,910	4,904	8,094
Common Dividends	307	348	457	409	502	530	625	633	1,601	2,290	3,091
Ratio (%)									40.9	45.9	43.7
Petroleum											
Earnings	132	120	187	234	269	165	167	192	693	773	1,466
Dividends	47	55	98	115	104	109	121	135	315	449	764
Ratio (%)									45.5	59.1	52.8
Manufacturing											
Earnings	514	506	621	677	613	681	870	868	2,340	3,032	5,392
Dividends	183	214	254	247	280	313	391	376	918	1,358	2,276
Ratio (%)									39.2	44.5	42.8

Table A3 (Concluded)

	1953	1954	1955	1956	1957	1958	1959	1960	1953-56	1957-60	1953-60
LATIN AMERICA: All Industries											
Earnings on Common	219	230	253	270	349	261	300	335	998	1,245	2,237
Common Dividends	66	107	98	60	106	110	98	111	331	431	764
Ratio (%)									33.0	33.3	33.0
Petroleum											
Earnings	56	57	53	61	93	40	53	56	203	242	445
Dividends	15	14	19	19	29	27	20	21	68	97	165
Ratio (%)									34.0	40.1	37.3
Manufacturing											
Earnings	94	106	94	96	101	90	108	126	390	421	811
Dividends	37	34	28	26	31	29	29	38	121	127	248
Ratio (%)									31.0	30.2	30.6
REST OF THE WORLD: All Industries											
Earnings on Common	380	410	460	515	728	533	548	635	1,601	2,308	4,109
Common Dividends	149	109	143	230	235	261	312	331	731	1,139	1,890
Ratio (%)									45.7	46.2	46.0
Petroleum											
Earnings	208	107	157	243	360	265	251	290	715	1,160	1,895
Dividends	79	92	66	125	180	170	210	221	371	781	1,052
Ratio (%)									51.9	61.1	57.6
Manufacturing											
Earnings	73	92	95	81	104	116	119	135	341	474	815
Dividends	28	37	33	31	46	53	57	58	129	214	343
Ratio (%)									37.8	45.1	42.1
LATIN AMERICA & THE REST OF THE WORLD: All Industries (Subtotal)											
Earnings on Common	607	640	712	804	1,071	814	849	1,019	2,593	3,753	6,346
Common Dividends	235	296	253	310	339	372	404	462	1,094	1,576	2,672
Ratio (%)									42.3	42.0	42.1
Petroleum											
Earnings	234	150	210	304	457	305	306	354	918	1,422	2,340
Dividends	94	115	87	144	149	197	230	242	440	818	1,258
Ratio (%)									47.9	57.5	53.8
Manufacturing											
Earnings	167	198	189	177	205	206	221	261	731	893	1,626
Dividends	65	71	59	55	77	82	86	96	250	341	591
Ratio (%)									34.2	38.1	36.3
WORLD: All Industries											
Earnings on Common	1,409	1,385	1,693	2,016	2,250	1,097	2,178	2,412	6,503	8,737	15,240
Common Dividends	542	646	712	799	841	901	1,009	1,095	2,697	3,866	6,563
Ratio (%)									41.5	44.2	43.1
Petroleum											
Earnings	306	270	397	558	726	670	473	546	1,611	2,215	3,826
Dividends	141	170	185	259	253	306	331	377	755	1,267	2,042
Ratio (%)									46.9	58.1	53.4
Manufacturing											
Earnings	601	726	810	854	838	887	1,091	1,111	3,071	3,947	7,018
Dividends	258	265	313	302	357	395	477	470	1,168	1,699	2,867
Ratio (%)									38.0	43.0	40.9

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Source: Information supplied by U. S. Department of Commerce; series will be published sometime in 1962, probably mid-year. Earnings differ from data in Table A1 in that they exclude profits of U.S. branches abroad. Dividends differ from Income data in Table A1 in that they exclude branch profits (all of which are reported as "Income" in the data in Table A1), as well as preferred dividends and interest payments.

Table A4
Royalties, Management Fees and Other Inflows, from Direct Investments, 1957 (by region)
(Millions of Dollars)

All Industries	Canada	Europe	Latin America	Rest of World	World	Canada & Europe	Latin America & Rest of World
Preferred Dividends	3	1	3	-	7	4	3
Interest	49	3	26	12	90	52	38
Sub-Total	52	4	29	12	97	56	41
Royalties	12	25	10	7	54	37	17
Management Fees	48	33	60	46	187	81	106
Sub-Total	60	58	70	53	241	118	123
TOTAL	112	62	99	65	338	174	164
Direct Investment, 1956	7,460	3,520	7,459	3,738	22,177	10,980	11,197
Ratio %	1.5	1.7	1.3	1.7	1.5	1.5	1.4
Manufacturing							
Preferred Dividends	2	-	1	-	3	2	1
Interest	18	2	2	-	22	20	2
Sub-Total	20	2	3	-	25	22	3
Royalties	7	19	9	3	38	26	12
Management Fees	31	26	12	10	79	57	22
Sub-Total	38	45	21	13	117	83	34
TOTAL	58	47	24	13	142	105	37
Direct Investment, 1956	3,196	1,861	1,543	552	7,152	5,057	2,095
Ratio	1.8	2.5	1.6	2.4	2.0	2.1	1.8

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Source: Compiled from data in Tables 41 and 47, U. S. Department of Commerce, U. S. Business Investments in Foreign Countries (1960). Since preferred dividends and interest payments from U. S. subsidiaries abroad are excluded from the series on Common Dividends in Table A3, but they are nevertheless inflows, they have been added here to royalties (which include licensing fees) and management fees in order to include all inflows on which information is available.

EXHIBIT III

Table A5

Estimated Effect on the Balance of Payments of New Capital Outflow to Manufacturing Subsidiaries in Canada and Western Europe, 1952-1960

(millions of dollars)

Year	Annual Capital Outflow	Computed Reinvested Earnings	Cumulative Increment to Outstanding Investment	Computed Dividends	Computed Royalties, fees, and net exports	Total Inflows	Cumulative Capital Outflow	Cumulative Net Inflows	Balance
1952	127		127				127		- 127
1953	20	10	157	9	13	22	147	22	- 125
1954	72	13	242	11	16	27	219	49	- 170
1955	90	19	351	16	25	41	309	90	- 219
1956	184	28	563	24	36	60	493	150	- 343
1957	304	45	912	38	58	96	797	246	- 551
1958	164	73	1149	61	94	155	961	401	- 560
1959	370	92	1610	77	118	195	1331	596	- 735
1960	638	128	2376	108	166	274	1969	870	-1099

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Source: This table makes use of actual data on capital outflow and of the parameter values for manufacturing subsidiaries on rate of return on investment, proportion of earnings distributed and reinvested, rate of payment of fees and royalties per dollar of investment, and value of net exports to subsidiaries per dollar of investment computed in Tables A1-A4 in the appendix and Table 4 in the text. In aggregating the data, the parameter values are weighted in accordance with the value of new capital outflow in manufacturing going to each region over the period 1957-1960, i.e. the weights for the sub-total Canada and Western Europe are 28.9 and 71.1 percent, respectively. These weights differ somewhat from those which are in effect applied in arriving at parameter values for sub-groups in Tables A1-A4 in the appendix and Table 4 in the text, for in those tables the weights are direct investment outstanding rather than new capital outflow. The latter weights would seem to reflect the current situation more than the former.

(continued)

Thus, the relevant parameter values used are computed as follows:

<u>Earnings</u> (Table A2)

Europe, 1957-60: 16.8 percent x 71.1 = 11.94
Canada, 1957-60: 9.6 percent x 28.9 = 2.77
14.71 percent

<u>Proportion of earnings remitted</u> (Table A3)

Europe, 1957-60: 46.7 percent x 71.1 = 33.2
Canada, 1957-60: 42.3 percent x 28.9 = 12.2
45.4 percent

Rate of return on investment which is remitted as a dividend: 6.7 percent
Rate of return on investment which is reinvested: 8.0 percent

These two figures are multiplied by the cumulative increment to outstanding investment of the previous period to obtain the figures in col. 2 and col. 4. The cumulative increment to outstanding investment each year, then, is the sum of the previous year's investment and the new capital outflow, plus reinvested earnings of the current year.

In a similar manner, the "rate of return" for royalties and fees, and for net exports are computed as follows:

<u>Royalties and fees</u> (Table A4)

Europe, 1957: 2.5 percent x 71.1 = 1.78
Canada, 1957: 1.8 percent x 28.9 = .52
2.30 percent

<u>Net exports</u> (Table 4)

Europe, 1959-60: 4.1 percent x 71.1 = 2.92
Canada, 1959-60: 17.7 percent x 28.9 = 5.12
8.04 percent

The sum of these two rates is then multiplied by the previous year's outstanding investment to yield the data in col. 5. Col. 6 is the sum of col. 4 and col. 5.

EXHIBIT II:

Table A6

Estimation of "Switch Effect" on the Balance of Payments as a Result of Eliminating Tax Deferral in Advanced Industrial Countries 1/

Year	Capital Outflow	Developments with Deferral: Undistributed Profits	Developments with Deferral: Direct Investment	Developments with Deferral: Dividends	Developments without Deferral: Undistributed Profits	Developments without Deferral: Direct Investment	Developments without Deferral: Dividends	Analysis of "Switch Effect": Annual Gain in Dividends Col. (7) - Col. (4)	Analysis of "Switch Effect": Cumulative Gain in Dividends	Analysis of "Switch Effect": Difference in Investment Without Deferral and With Deferral Col.(6)-Col.(3)	Analysis of "Switch Effect": Annual Loss in Net Exports, etc. (10% of Col.10)	Analysis of "Switch Effect": Cumulative Loss in Net Exports, etc.
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
0			10,000			10,000				0		
1	1,000	650	11,650	550	550	11,550	650	+ 100	+ 100	- 100	- 10	- 10
2	1,100	757	13,507	641	635	13,285	751	+ 110	+ 210	- 222	- 22	- 32
3	1,210	878	15,595	743	731	15,266	864	+ 121	+ 331	- 329	- 33	- 65
4	1,331	1,014	17,940	858	840	17,437	992	+ 134	+ 465	- 503	- 50	- 115
5	1,464	1,166	20,570	987	959	19,860	1,133	+ 146	+ 611	- 710	- 71	- 186
6	1,610	1,337	23,517	1,131	1,092	22,562	1,291	+ 160	+ 771	- 955	- 96	- 282
7	1,771	1,529	26,817	1,293	1,241	25,574	1,467	+ 174	+ 945	- 1,243	- 124	- 406
8	1,949	1,743	30,509	1,475	1,407	28,930	1,662	+ 187	+ 1,132	- 1,579	- 158	- 564
9	2,143	1,983	34,635	1,678	1,591	32,644	1,880	+ 202	+ 1,334	- 1,991	- 199	- 763
10	2,358	2,251	39,244	1,905	1,795	36,797	2,122	+ 217	+ 1,551	- 2,447	- 245	- 1,008
11	2,593	2,551	44,388	2,158	2,024	41,414	2,392	+ 234	+ 1,785	- 2,974	- 297	- 1,305
12	2,853	2,885	50,126	2,441	2,278	46,545	2,692	+ 251	+ 2,036	- 3,581	- 358	- 1,663
13	3,138	3,258	56,522	2,757	2,560	52,243	3,025	+ 268	+ 2,304	- 4,279	- 430	- 2,093
14	3,452	3,674	63,648	3,109	2,873	58,568	3,396	+ 287	+ 2,591	- 5,000	- 508	- 2,601
15	3,797	4,137	71,582	3,501	3,221	65,586	3,807	+ 306	+ 2,897	- 5,996	- 600	- 3,201
16	4,177	4,653	80,412	3,937	3,607	73,370	4,263	+ 326	+ 3,223	- 7,042	- 704	- 3,905
17	4,595	5,227	90,234	4,423	4,035	82,000	4,769	+ 346	+ 3,569	- 8,234	- 823	- 4,728

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1/ Table A6 is based on the following assumptions: 1. Capital outflow grows at 10 percent a year, with or without deferral (i.e., for purposes of analysis we separate out the "deterrent" effect to be considered subsequently, and assume it zero here). With deferral, earnings are 12 percent of direct investment outstanding and 46 percent of earnings are distributed, 54 percent retained, so that retained earnings are 6.5 percent of direct investment outstanding in the previous year, dividends 5.5 percent of this figure. Without deferral the proportion of earnings retained and distributed are reversed, and thus 6.5 percent of direct investment outstanding is distributed, 5.5 percent retained. The gain in dividends in Col. (8) is thus the difference in dividends paid without deferral and dividends paid with deferral, or Col. (7) minus Col. (4). Since, however, there are smaller undistributed profits each year when deferral is eliminated, and thus direct investment outstanding increases more slowly, this affects receipts from fees, royalties, and "net exports," which are diminished by approximately 10 percent of the decrease in investment outstanding because of the reduction in reinvested earnings. The beginning figure of $10 billion is a loosely rounded estimate of U.S. manufacturing investment outstanding in all developed countries in 1961, for ease in computation.

EXHIBIT III

Table A7

Estimation of "Deterrent Effect" on the Balance of Payments as a Result of Eliminating Tax Deferral in Advanced Industrial Countries

(Millions of dollars)

Year	Annual reduction in capital outflow	Cumulative reduction in capital outflow	Annual change in earnings	Annual change in reinvested earnings	Change in direct investment outstanding	Annual change in dividends	Cumulative change in dividends	Annual change in royalties and fees	Annual change in net exports	Cumulative change in royalties, fees, and net exports	Annual change in total inflows	Cumulative change in total inflows	Annual change in net outflow	Cumulative change in net outflow
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
0	100	100	-	-	- 100	-	-	-	-	-	-	-	+ 100	+ 100
1	110	210	- 15	- 8	- 218	- 7	- 7	- 2	- 8	- 10	- 17	- 17	+ 93	+ 193
2	121	331	- 32	- 17	- 356	- 15	- 22	- 5	- 17	- 32	- 37	- 54	+ 84	+ 277
3	133	464	- 52	- 29	- 528	- 24	- 46	- 8	- 29	- 69	- 61	- 115	+ 72	+ 350
4	146	610	- 76	- 41	- 706	- 35	- 81	- 12	- 41	- 122	- 88	- 203	+ 58	+ 408
5	161	771	- 104	- 57	- 923	- 47	- 128	- 16	- 57	- 195	- 120	- 323	+ 41	+ 449
6	177	948	- 136	- 74	- 1,174	- 62	- 190	- 21	- 74	- 290	- 157	- 480	+ 20	+ 469
7	195	1,143	- 173	- 94	- 1,463	- 79	- 269	- 27	- 94	- 411	- 200	- 680	- 5	+ 464
8	214	1,357	- 215	- 117	- 1,794	- 98	- 367	- 34	- 117	- 562	- 249	- 929	- 34	+ 430
9	236	1,593	- 264	- 1[illegible]	- 2,174	- 120	- 487	- 41	- 144	- 747	- 305	- 1,234	- 69	+ 361
10	259	1,852	- 320	- 174	- 2,607	- 146	- 633	- 50	- 174	- 971	- 370	- 1,604	- 110	+ 251
11	285	2,137	- 383	- 209	- 3,101	- 175	- 808	- 60	- 209	- 1,240	- 443	- 2,048	- 158	+ 93
12	314	2,451	- 456	- 248	- 3,663	- 208	- 1,016	- 71	- 248	- 1,559	- 527	- 2,575	- 213	- 121

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Source: This table is computed in the same manner as Table A5, except that instead of using actual data on new capital outflow for 1952-60, this variable is assumed to grow at 10 percent a year.

B. Income Earned Abroad by Individuals

Table 1 - Number of individual returns claiming bona fide foreign residence, amount of income excluded, and amount of adjusted gross income reported, classified by amount of excluded income, 1960

This table shows that there were over 41,000 individual tax returns claiming exemption from tax on earned income derived abroad because they were bona fide residents of a foreign country. They excluded approximately $440 million of income and reported taxable income of $65 million. Data with respect to persons remaining abroad for 17 out of 18 months are shown in the following two tables.

Table 2 - Number of returns claiming exemption from tax on income earned abroad, amounts of excluded income and of taxable income, by selected countries and in the aggregate, 1960

This table shows that approximately 14,000 returns were filed by individuals who are bona fide residents of Western Europe and industrialized countries elsewhere in the world. Over 27,000 returns were filed by persons resident in other countries, which may be considered the less developed countries of the world. It also includes the data for the individual countries.

Table 3 - Number of returns claiming exemption from tax on income earned abroad, amounts of excluded income and of taxable income, classified by size of excluded income, for (a) Western European countries and other industrialized countries 1/, (b) other countries, and (c) in the aggregate, 1960

This table contains substantially the same data as the preceding one but classifies the information by the amount of income exempt from tax.

Table 4 - Individuals claiming exemption of $100,000 or more in 1959 or 1960 as bona fide residents of a foreign country showing the country of residence, occupation and the amount of income excluded from tax in each year

This table shows for individuals who claimed exemption of $100,000 or more in either 1959 or 1960 as bona fide residents of a foreign country, the country of residence, occupation and the amount of income excluded from tax in each year. While there is some fluctuation from one year to the other, in most cases large amounts were excluded in both years.

Table 1

Number of individual returns claiming bona fide foreign residence, amount of income excluded, and amount of adjusted gross income reported, classified by amount of excluded income, 1960

(Amounts in thousands)

Size class of excluded income	Number of returns	Excluded income	Adjusted gross income reported
Under - $ 5,000	13,224	$ 35,211	$ 13,983
$ 5,000 - 10,000	8,682	64,763	11,095
10,000 - 20,000	13,471	192,118	18,951
20,000 - 30,000	3,456	81,553	9,261
30,000 - 35,000	508	16,330	1,921
35,000 - 40,000	297	11,007	1,347
40,000 - 50,000	286	12,538	1,794
50,000 - 100,000	269	17,063	3,471
100,000 - 500,000	52	7,845	1,214
500,000 & over	2	1,939	182
Not reported	951	-	2,011
Total	41,198	440,369	65,221

March 17, 1962

Source: Internal Revenue Service, Form 2555

Table 2

Number of returns claiming exemption from tax on income earned abroad, amounts of excluded income and of taxable income, by selected countries and in the aggregate, 1960

Country	Bona Fide Residence			Physical Presence			Aggregate		
	Number	Amount Income Excluded	Amount Adjusted Gross Income	Number	Amount Income Excluded	Amount Adjusted Gross Income	Number	Amount Income Excluded	Amount Adjusted Gross Income
Austria	92	$ 725,863	$ 213,806	41	$ 293,562	$ 116,663	133	$ 1,019,425	$ 332,469
Portugal	55	531,028	99,483	48	437,338	102,501	103	968,366	201,984
Belgium	218	2,532,394	464,652	51	449,873	80,511	269	2,982,267	545,163
Spain	280	2,969,601	701,069	309	2,538,045	547,984	589	5,507,646	1,249,053
United Kingdom	1,108	15,544,261	4,567,804	919	6,598,581	2,495,137	2,027	22,142,842	7,062,941
France	1,096	13,486,328	3,569,946	401	3,098,547	1,199,195	1,497	16,584,675	4,769,141
Denmark	55	439,414	133,104	43	398,549	67,412	98	837,963	200,516
Greece	134	1,134,311	316,963	87	654,690	109,455	221	1,789,001	426,418
Germany	1,095	10,629,612	1,825,320	974	6,575,176	2,112,063	2,069	17,204,788	3,937,383
Finland	10	43,499	2,873	2	8,752		12	52,251	2,873
Ireland	26	210,636	46,259	13	101,415	35,864	39	312,051	82,123
Italy	678	7,262,224	1,456,352	326	3,525,710	563,549	1,004	10,787,934	2,019,901
Norway	43	319,390	76,620	43	396,966	50,059	86	716,356	126,679
Liechtenstein & Switzerland	686	10,979,958	2,754,809	113	826,222	346,128	799	11,806,180	3,100,937
Luxembourg	28	364,997	68,543	6	55,432	9,476	34	420,429	78,019
Netherlands	297	4,256,758	727,163	93	838,570	224,280	390	5,095,328	951,443
Sweden	129	1,016,066	153,415	33	184,927	88,591	162	1,200,993	242,006
Turkey	305	3,005,626	446,120	374	3,213,283	671,306	679	6,218,909	1,117,426
Canada	5,224	54,049,813	8,490,878	405	2,697,858	983,160	5,629	56,747,671	9,474,038
Japan	1,667	12,377,725	1,825,774	842	5,567,359	1,995,720	2,509	17,945,084	3,821,494
Australia	289	3,227,239	639,991	100	1,001,477	158,914	389	4,228,716	798,905
South Africa	276	1,914,669	233,715	33	224,087	44,585	309	2,136,756	278,300
Subtotal	13,791	147,021,412	28,814,659	5,256	39,686,419	12,004,573	19,047	186,707,831	40,819,232
Other Countries	27,407	293,347,401	36,406,340	7,353	66,227,199	12,632,022	34,760	359,574,600	49,038,362
TOTAL	41,198	$440,368,813	$65,220,999	12,609	$105,913,618	$24,636,595	53,807	$546,282,431	$89,857,594

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Table 3

Number of returns claiming exemption from tax on income earned abroad, amounts of excluded income and of taxable income, classified by size of excluded income, for (a) Western European countries and other industrialized countries 1/, (b) other countries, and (c) in the aggregate, 1960

Amount of Excluded Income	Bona Fide Residence			Physical Presence			Aggregate		
	Number	Amount Income Excluded	Amount Adjusted Gross Income	Number	Amount Income Excluded	Amount Adjusted Gross Income	Number	Amount Income Excluded	Amount Adjusted Gross Income
Industrialized Countries: 1/									
Total	13,791	$147,021,412	$28,814,659	5,256	$39,686,419	$12,004,573	19,047	$186,707,831	$40,819,232
Not reported	463		976,956	141		435,620	604		1,412,576
Under $5,000	4,190	11,035,022	6,179,894	1,740	4,280,353	5,922,412	5,930	15,315,375	12,102,306
$5,000 under $10,000	3,389	25,132,707	4,765,427	1,761	13,250,742	3,037,037	5,150	38,383,449	7,802,464
$10,000 under $20,000	4,186	58,377,191	7,635,890	1,546	20,579,104	2,250,633	5,732	78,956,295	9,886,523
$20,000 under $50,000	1,401	38,758,381	6,290,278	67	1,452,909	358,871	1,468	40,211,290	6,649,149
$50,000 under $100,000	132	8,494,431	2,052,008				132	8,494,431	2,052,008
$100,000 under $500,000	29	4,123,889	809,504	1	123,311		30	4,247,200	809,504
$500,000 and over	1	1,099,791	104,702				1	1,099,791	104,702
Other Countries:									
Total	27,407	293,347,401	36,406,340	7,353	66,227,199	12,632,022	34,760	359,574,600	49,038,362
Not Reported	488		1,034,069	129		253,326	617		1,287,395
Under $5,000	9,034	24,176,034	7,803,795	1,667	4,427,402	5,205,923	10,701	28,603,436	13,009,718
$5,000 under $10,000	5,293	39,630,545	6,329,655	2,457	19,041,409	3,192,944	7,750	58,671,954	9,522,599
$10,000 under $20,000	9,285	133,740,808	11,315,036	2,913	38,765,398	3,257,408	12,198	172,506,206	14,572,444
$20,000 under $50,000	3,146	82,670,917	8,022,818	187	3,992,990	722,421	3,333	86,663,907	8,745,239
$50,000 under $100,000	137	8,568,881	1,419,314				137	8,568,881	1,419,314
$100,000 under $500,000	23	3,721,073	404,032				23	3,721,073	404,032
$500,000 and over	1	839,143	77,621				1	839,143	77,621
All Countries:									
Total	41,198	440,368,813	65,220,999	12,609	105,913,618	24,636,595	53,807	546,282,431	89,857,594
Not Reported	951		2,011,025	270		688,946	1,221		2,699,971
Under $5,000	13,224	35,211,056	13,983,689	3,407	8,707,755	11,128,335	16,631	43,918,811	25,112,024
$5,000 under $10,000	8,682	64,763,252	11,095,082	4,218	32,292,151	6,229,981	12,900	97,055,403	17,325,063
$10,000 under $20,000	13,471	192,117,999	18,950,926	4,459	59,344,502	5,508,041	17,930	251,462,501	24,458,967
$20,000 under $50,000	4,547	121,429,298	14,313,096	254	5,445,899	1,081,292	4,801	126,875,197	15,394,388
$50,000 under $100,000	269	17,063,312	3,471,322				269	17,063,312	3,471,322
$100,000 under $500,000	52	7,844,962	1,213,536	1	123,311		53	7,968,273	1,213,536
$500,000 and over	2	1,938,934	182,323				2	1,938,934	182,323

1/ Includes the countries of Austria, Portugal, Belgium, Spain, United Kingdom, France, Denmark, Greece, Germany, Finland, Ireland, Italy, Norway, Liechtenstein, Switzerland, Luxembourg, Netherlands, Sweden and Turkey.

Table 4

Individuals claiming exemption of $100,000 or more in 1959 or 1960 as bona fide residents of a foreign country, showing country of residence, occupation, and amount of income excluded from tax in each year

COMPARATIVE STATEMENT FOR 1959 AND 1960 OF INDIVIDUALS WHO EXCLUDED $100,000 OR MORE UNDER SECTION 911 IN EITHER 1959 OR 1960

TAXPAYER *	COUNTRY	OCCUPATION	EXCLUDED INCOME 1959	EXCLUDED INCOME 1960
C-2-J	Germany	Sales Representative	98,291	208,549
C-3-S	Venezuela	Lawyer	129,570	60,911
C-4-S	Thailand	Sales Representative	31,986	119,495
C-6-J	Brazil	Corp. Executive	144,033	252,402
C-7-J	Venezuela	C.P.A.	Chg. Detroit Office	116,180
C-8-J	Venezuela	Industrialist	95,262	146,065
C-9-J	Switzerland	Actor	136,000	Not Claimed
C-10-S	Germany	Life Ins. Salesman	160,450	123,793
C-11-J	Venezuela	---	119,531	93,764
C-12-J	United Kingdom	Executive	99,936	117,579
C-13-J	Switzerland	Executive	117,556	179,912
C-14-J	Canada	Executive	No Record	127,897
C-15-S	Canada	Self Employed	126,750	No Record
C-16-J	Mexico	Commercial Relations	No Record	185,268
C-17-S	United Kingdom	Executive	44,800	105,366
C-18-J	United Kingdom	Writer & Producer	142,500	131,133
C-19-S	France	Manager	115,323	60,020
C-20-J	Australia	Executive	130,768	No Record
C-21-S	Switzerland	Insurance Agent	155,360	79,448
C-22-J	Brazil	---	Not Claimed	106,423
C-23-J	Canada	Executive	136,700	136,800
C-24-S	Switzerland	Actor	2,126	163,336
C-25-J	Venezuela	Corp. President	105,145	104,800
C-26-J	England	Writer	217,540	200,000
C-27-J	Venezuela	General Manager	107,367	73,063
C-28-S		Actress	996,200	97,150
C-29-J	Italy	Executive	45,000	143,321
C-31-J	Philippines	Executive	265,540	43,961
C-32-J	Canada	Industrialist	52,500	152,098
C-33-S	Switzerland	Housewife	Not Claimed	1,099,791
C-34-S	Switzerland	Actor	Not Claimed	1,099,791
C-35-J	Philippines	Executive	863,295	125,738
C-36-J	Mexico	---	No Record	160,863
C-37-J	Argentina	---	99,349	126,139
C-39-J	Switzerland	Cartoonist	No Record	110,315
C-40-J	Brazil	Engineer	33,095	107,676
C-41-J	Japan	Executive	124,909	232,944
C-43-J	Argentina	Mfg. Representative	217,121	164,422
C-44-S	Switzerland	Sales Agent	22,199	127,344
C-45-J	Brazil	---	125,000	125,000
C-46-S	Switzerland	Producer Director	144,000	172,142
C-47-J	Italy	Director	45,000	161,000
C-48-J	Argentina	Engineer	Not Reported	109,381
C-51-J	Canada	Executive	84,764	112,510
C-52-J	United Kingdom	Executive	130,768	134,577
C-53-J	Venezuela	Executive	111,244	127,851
C-54-J	Switzerland	Motion Picture Producer	No Record	102,750
C-55-J	Cuba	Executive	85,000	111,666
C-56-J	Philippines	Lawyer	108,638	No Record
C-57-S	France	Executive	106,850	184,875
C-58-S	South Viet-Nam	---	89,103	110,687
C-59-J	Japan	Engineer	99,927	102,980
C-60-J	Philippines	Lawyer	93,949	114,605
C-61-S	Japan	Engineer	122,260	85,915
C-62-S	Dominican Republic	Gambling Operator	150,059	8,400
C-63-J	Canada	Executive	107,088	146,144
C-64-J	United Kingdom	Engineer	Not Claimed	118,862
C-65-S	Brazil	Executive	79,053	242,700
C-66-J	Venezuela	Engineer	133,078	16,000
C-67-S	Mexico	---	99,840	103,000
C-68-S	Venezuela	Manager	161,083	113,660
C-69-J	Mexico	Executive	22,916	142,914
C-70-J	Lebanon	Executive	131,167	16,250
C-71-J	Canada	Executive	84,764	107,831
C-72-J	Venezuela	Vice President	107,000	81,000
C-73-S	Canada	---	28,443	123,311
C-74-J	Germany	Banker	112,764	116,783
C-75-J	Hong Kong	Lawyer	30,145	468,649
C-76-J	Brazil	Executive	563,077	839,143
C-77-J	Brazil	Cotton Merchant	69,359	154,761
C-78-J	Germany	Auto. Executive	160,776	171,910

* Internal Revenue Service identifying numbers. J indicates joint return filed; S indicates separate return filed.

March 27, 1962

C. DATA ON TAX HAVEN SUBSIDIARIES

Table 1 - Number of foreign corporations created by U.S. interests as reported to IRS on Form 959, for selected "tax haven" countries and for all countries by years of incorporation 1955-61 and for all years

This table indicates that about 3,500 information returns with respect to the creation of a foreign subsidiary have been filed with the Internal Revenue Service through 1961. This filing was pursuant to requirements of the Internal Revenue Code. The inadequacy of both the requirements and the compliance in most past years is revealed by a comparison of this table with the following one.

Table 2 - Subsidiaries in selected "tax haven" countries and total in all countries in 1959 for a group of 1,075 U.S. corporations, classified by year of incorporation of subsidiaries

This table was based on information collected by Internal Revenue agents with respect to a group of corporations comprised in large measure of those that happened to be under audit during a particular period in 1961. These companies reported that they had more than 4,200 foreign subsidiaries, which were organized during the years through 1959. This table indicates that the bulk of the subsidiaries incorporated in so-called tax haven countries were formed subsequent to 1954. Tables 1 and 3 confirm this.

Table 3 - Swiss corporations controlled by U.S. interests and by those in selected European countries, by years 1958-61, and in the aggregate

This table, based upon a study of information published in the official Swiss commercial register, indicates that over a thousand Swiss subsidiaries created by U.S. interests were in existence at the end of 1961. Most of these were established from 1958 on. Subsidiaries created by interests situated in other industrialized countries are also shown, and the number of such subsidiaries controlled in each of the other countries is substantially less than those controlled by U.S. interests. Moreover, most of them were established prior to 1958.

Table 4 - Swiss firms owned by U.S. interests, classified by type of business activity, 1961

This table indicates that of the Swiss companies established by U.S. interests, one-fourth of the companies reported manufacturing among the purposes for which they were established. About two-thirds are sales, licensing and holding companies. Motion picture producing was relatively important, accounting for 32 companies.

Table 1
Number of foreign corporations created by U. S. interests as reported to IRS on Form 959, for selected "tax haven" countries and for all countries by years of incorporation 1955-61 and for all years

Year	Switzerland	Panama	Venezuela	Bahamas	Liberia	All countries
1955		40	10	4	109	232
1956		64	17	4	163	349
1957		99	23	2	113	364
1958	2	95	16	15	82	336
1959	6	134	8	27	59	423
1960	70	101	16	61	49	676
1961	78	42	9	37	17	603
Total, 1955-1961	156	575	99	150	592	2,983
Total, All years	157	730	104	152	592	3,479

Source: Internal Revenue Service

April 2, 1962

Table 2
Subsidiaries in selected "tax haven" countries and total in all countries in 1959 for a group of 1075 U.S. corporations, classified by year of incorporation of subsidiaries

Year	Bahamas 1/	Panama	Venezuela	Switzerland	Liberia	All countries
1959	10	33	12	49	3	339
1958	8	31	16	26	7	296
1957	9	43	27	12	6	316
1956	4	26	25	12	8	277
1955	5	23	21	4	6	267
1955-59	36	156	103	103	30	1,495
1950-59	46	200	126	118	47	2,285
1940-49	8	20	28	11	3	621
1939 & prior years	3	13	3	16	-	1,325
Total, all years	57	233	157	145	50	4,231

April 2, 1962

Source: Internal Revenue Service (IO-362, VI)

1/ Includes Bermuda

Table 3
Swiss corporations controlled by U. S. interests and by those in selected European countries, by years 1958-61, and in the aggregate

Year	U.S. 1/	Germany 2/	U.K. 3/	France	Nether-lands	Belgium
1961	229	124	27	12	14	4
1960	287	110	38	29	15	5
1959	164	92	22	26	15	6
1958	88	42	20	29	6	2
Prior to 1958	257	348	123	251	62	52
Total, all years	1,025	716	230	347	112	69

April 2, 1962

Source: Compiled from the official Swiss commercial register.

1/ Total includes 229 firms considered American controlled, because the listed director, officer, or other responsible functionary is a Swiss attorney known to specialize in the organization of Swiss companies for American clients. Experience has shown that in these cases often after a time a U.S. firm emerges as the controlling interest. Some of the companies considered owned by the U.K., etc. may also be American controlled. See footnote 3/.

2/ German tax officials consider the figures to be too high as an index of tax haven operations, and ascribe many of the companies to German nationals living in Switzerland and conducting small enterprises there that have no direct tie to the German economy.

3/ Includes an undetermined number of Swiss companies controlled by U.K. companies which in turn are subsidiaries of U.S. companies. This may also be true of the other countries shown.

Table 4

Swiss firms owned by U.S. interests, classified by type of business activity, 1961

Business activity 1/	Number
Manufacturing	243
Sales or purchasing offices	293
Licensing of patents, know-how, engineering and technical services	151
Motion picture producing	32
Holding companies	177
Other activities	126
Not reported	3
Total	1,025

Source: Internal Revenue Service April 2, 1962

1/ Most companies are organized to engage in more than one type of activity. Duplicate counting has been avoided in this table by excluding from each category companies that have been included in categories listed above it. Thus, "manufacturing" includes all companies that engage in other activities besides manufacturing, while none of the other categories include any company engaged in manufacturing.

D. ADMINISTRATIVE PROBLEMS CONNECTED WITH THE AUDITING OF CASES INVOLVING CONTROLLED FOREIGN CORPORATIONS

The following memorandum from Mortimer Caplin, the Commissioner of Internal Revenue Service details the administrative problems that are encountered in the handling of cases by the Internal Revenue Service involving the use of controlled foreign corporations. Much of the data contained in the memorandum is based on the Internal Revenue Service's experience with 39 cases involving avoidance of U. S. income tax in foreign activities thatwere contained in a memorandum of the Commissioner dated June 19, 1961. This memorandum was made part of the record in the hearings before the Committee on Ways and Means of the House of Representatives on the President's 1961 tax recommendations held June 5 through 9, 1961 (see Vol. 4, page 3534):

Jan. 30, 1962

MEMORANDUM FOR: Honorable Stanley S. Surrey
Assistant Secretary

SUBJECT: Problems of Administration of the Revenue Laws Relating to the Taxation of Foreign Income

Under dates of June 19, 1961, and June 22, 1961, the Service addressed memoranda to you on the above subject in which was described typical cases under examination involving tax avoidance in foreign activities of domestic taxpayers, and the principal administrative problems encountered by the Service in connection with such cases.

In response to your request, I am submitting supplemental detailed data (Exhibit A) developed during the examination of these cases, and additional information concerning the potential over-all workload of cases involving international transactions and the estimated average time which will be required to examine these returns.

WORKLOAD OF CASES

A recent survey discloses that as of January 1, 1962, the number of cases involving substantial foreign transactions selected for examination by our district offices totaled 3,044 domestic taxpayers, involving 6,800 foreign affiliates. These returns were selected on the basis of limited audit information reflected in the returns filed for taxable years prior to 1961. However, for taxable years beginning after December 31,

1960, corporations will be required, under the provisions of Section 6038 of the Code, to furnish additional information regarding foreign corporations and subsidiaries of foreign corporations controlled directly or indirectly by the domestic corporation. This additional audit information will facilitate the selection of cases for examination, and we can expect that this will result in a substantial increase in the number of returns identified and selected for examination.

Aside from the question as to the number of returns filed by taxpayers engaged in foreign activities that must be examined in connection with our foreign enforcement program, notice should be taken of the time and skills required to adequately examine this type of case. As was pointed out in the memorandum of June 22, 1961, the examinations require the use of only the most experienced revenue agents who have been thoroughly trained in the application of Section 482 of the Code which is applicable in practically all of this type of case.

Our experience with the 39 cases submitted to you with our memorandum dated June 1961, discloses that the time expended by revenue agents averaged 44 days. The other cases which are still pending involve an expenditure of an average of 98 days. As to these latter cases, it has been estimated that an average of 47 additional days will be required to complete the examinations. This data relates to the time required to close all of the tax years involved in these cases. In terms of tax years, our computations result in an average examination time of 24 days per tax year to complete the examinations.

The complexity of the examination of returns involving foreign transactions and its impact on our enforcement program is vividly illustrated by contrasting the man-hours of examination time required in such cases with the man-hours spent on all corporate returns disposed of by examination. For purposes of comparison, the average examination time per corporate return, broken down by asset classes is:

Asset Class of Each Return	Average Man-Hours per Return
No balance sheet	13.4
Under $50,000	10.6
$50,000 under $100,000	12.0
$100,000 under $250,000	13.8
$250,000 under $500,000	16.9
$500,000 under $1,000,000	20.1
$1,000,000 under $5,000,000	28.0
$5,000,000 under $10,000,000	42.4
$10,000,000 under $50,000,000	66.1
$50,000,000 under $100,000,000	99.0

It can be readily determined from this table that the average examination time per return ranges from a low of 1.25 days to a high of 12.5 days.

The 39 cases involving substantial foreign transactions upon which the average examination time is based do not include any of the so-called industrial giants, so we have not included in the above table the average examination time devoted to returns filed by these corporations.

The matter of greatest concern to the Service is the tremendous inroads being made on the available examination time of experienced agents so vitally essential to the audit coverage necessary to maintain the highest degree of voluntary compliance among taxpayers whose returns are generally examined by these revenue agents.

These returns must be examined by the most experienced agents, GS-12 and GS-13. Applying the average examination time of 24 man-days per case determined in connection with the 39 cases described above to the 3,044 returns in inventory as of January 1, 1962, the examination of these returns would involve an expenditure of 73,046 man-days, or approximately 289 man-years. These 289 man-years represent about 20 per cent of the GS-12 and GS-13 revenue agents available throughout the Nation for this type of work. (See Exhibit B). If these agents were available for regular examinations in the same ratio, they would be expected to examine about 20,000 returns rather than only 3,044.

This data clearly indicates that a disproportionate amount of revenue agent time is devoted to the examination of cases with international issues, which will have an adverse effect on the over-all desirable total audit coverage so essential to assure a high degree of voluntary compliance.

AUDITING TECHNIQUES

In the examination of corporate returns involving foreign transactions, very detailed and time-consuming auditing techniques must be utilized by the examining officer. I would like to mention briefly some of the extensive auditing steps the agents must take to determine the proper allocation of income and deductions between related corporations.

In making allocations of income and deductions between related corporations, the examining officer is required to do a number of things depending upon the type of activity, i.e., sales of goods or services. If only the sale of goods is involved, the examination may require certain data not pertinent regarding sales of services, and vice versa. If sales of both goods and services are involved, then the requirements of both must be met.

GENERAL CONSIDERATIONS

In the course of any examination the agent must determine whether the foreign and domestic entities are doing business with each other. If so, he must determine whether the corporations (1) have common officers, (2) have interlocking directorates, or (3) are dominated or controlled by the domestic entity.

If the corporations are doing business with each other, and especially if the answer to (1), (2) or (3) is affirmative, the agent must inquire into matters of special consideration, depending upon whether goods, services, or both, are involved.

SPECIAL CONSIDERATIONS

Where sales of goods are involved, the agent must determine the need, or lack of it, to reallocate income arising from intercompany sales. This means the agent must determine whether the intercompany prices are prices that would prevail in transactions between unrelated parties. Usually this is done by:

a. Securing copies of the sales agreements between the related entities and comparing them with any similar agreements with unrelated entities, both before and after the creation of the foreign entity.

b. Analyzing sales journals or other sales invoice data to determine the amount of sales between the domestic entity and related and unrelated foreign entities.

c. Obtaining information regarding foreign activities prior to the creation of the foreign entity to establish a comparative basis of operations.

d. Examining and comparing sales and credit memorandums as between unrelated domestic companies and foreign purchasers either related or unrelated to establish whether there are unwarranted price differentials.

e. Questioning company officials regarding differences in selling prices or unusual discounts and allowances.

f. Reconstructing intercompany sales found "out of line" to fair market basis.

If it is determined that price reallocations are necessary, there are two principal courses available, both fraught with difficulty. First, the agent can obtain data regarding selling prices and practices of comparable products and competing sellers. Second, if there are no competing products he must resort to cost accounting methods and make a decision as to the fair market value or cost of each activity to fairly allocate the income.

What I have said regarding pricing of sales is, of course, equally applicable regarding costs of sales and similar examination techniques must be employed to ascertain that each affiliated company bears all and only its proper share of costs.

Where sales of services are involved such as the providing of "know how" and the companies are related, or there are patents and copyrights involving royalty income and expense, the problem is even more difficult to solve. In these situations shifting of income is easily arranged but difficult to detect. Also, the domestic may divert its royalty income by transfer of its patent or copyright to the foreign affiliate without regard to the nature of any ruling pursuant to Section 367 of the Code. In these situations, the agent must:

a. Obtain copies of the licensing agreements to compare them with licensing agreements that may have been made with unaffiliated licensees.

b. Compare the royalty rates with those usually prevailing in the industry.

c. Determine whether the licenses are exclusive.

d. Determine whether provision has been made for technical assistance.

e. Determine whether or not there are provisions relating to patent improvements and new patents. The agent must also establish whether the royalty income of the domestic entity was greater or less before and after the creation of the foreign entity. He must also determine whether the licensees of the foreign entity to whom the patent or copyright was transferred were the same licensees under the patents or copyrights when held by the domestic entity.

OTHER CONSIDERATIONS

Income shifting is accomplished in other ways, for example:

a. Intercompany loans.

b. Charging or paying excessive management or technical service fees.

Here, again, the agent must have access to intercompany agreements; he must obtain data of charges for comparable services from competitive or third-party sources; he must determine whether the interposition of the foreign entity has resulted in any real substantive change other than the shifting of income.

All of these matters relate to facts peculiarly within the knowledge of the taxpayer concerned, without whose cooperation the agent is seriously handicapped.

ILLUSTRATION OF EXAMINATION TIME REQUIRED

The following partial case history is illustrative of the obstacles, complexities and delays encountered by examining personnel in auditing the class of case under discussion. The experience with this case is typical and accounts for the disproportionate amount of time devoted to these cases.

In 1959 the corporation selected for examination had $204,759,000 in assets and had 13 foreign subsidiaries. It also was affiliated with five other foreign corporations in which it owned

less than 50 percent. The majority of these corporations were organized prior to 1956 and are manufacturing corporations. One of the corporations is considered as a tax-haven subsidiary, and was organized in 1956. The parent company granted the subsidiary a non-exclusive licence to grant sub-licenses to its products for no consideration. Tax-haven subsidiary also purchased the license operations of a third party. The parent company also had a foreign license business, but only one of its licenses was transferred to the subsidiary. The parent company continued to receive license income, and nearly all the license income from its products received by the subsidiary was new business generated by that company.

The tax-haven subsidiary through 1960 returned approximately $470,000 of the earnings of over $600,000 in the form of dividends to the parent company. In recent years the domestic parent company's operations have resulted in losses.

During the examination much opposition was received from the taxpayer in obtaining basic information. The examination was conducted through the corporation's tax section which contained an attorney and an accountant who was the Federal tax administrator.

There follows a summary of the types of information requested, and a recitation of the disputes and delays which were encountered in obtaining responses:

1. History of each foreign subsidiary, capitalization, and a brief summary of the type of business operations.

2. Financial statements of the foreign subsidiaries for the current years under examination.

The tax section of the corporation took the position that the agent had no statutory authority to obtain this information since Section 6046 was enacted to include only years subsequent to the examination. The agent replied that this information was necessary to verify the tax returns. The question was referred to the corporation's legal section, and after several days of cajoling the taxpayer presented the information in a piece-meal fashion. The information on the tax-haven subsidiary was withheld for a period of time since the taxpayer considered

that the economic espionage laws of the tax-haven country prevented them from giving the Service the information.

3. Books and records of the tax-haven country subsidiary.

The taxpayer requested that the agent cite his authority to require the production of records of an alien corporation not engaged in business in the United States. The agent explained it was necessary to have the records to verify the parent company's return. The economic espionage laws of the tax-haven country prevented the parent company from bringing the records to the United States, according to the tax section.

4. License agreements of the tax-haven subsidiary.

The taxpayer's tax section stated that the foreign subsidiary wrote the license agreements and they did not believe copies were available in the United States. The tax section also asked why the agent needed the information. The agent explained he needed the information to determine if Sections 482 and 367 applied. The taxpayer wanted a detailed explanation of what this information would prove under these sections, and then started to argue the case before the agent had obtained any basic facts. The taxpayer also stated that this type of information was not available to the Service because of the foreign country's economic espionage laws.

After about a wek of exchanges of this type, the taxpayer relented and brought the licensing agreements out, one at a time, in a painfully slow process. It was necessary to obtain this information to determine whether any license income had been shifted from the parent company and to verify allocation of the license income among the licensed products.

5. Correspondence between the managing director, also the founder of the corporation, and the parent company.

The taxpayer claimed privilege on this correspondence under United States v. United Shoe Machinery Corporation, 89 Fed. Supp. 357, since this correspondence was either with parent company's secretary who is an attorney in the corporation's legal section or in some other undisclosed capacity. The

tax section warned the agent to confine his examination to the audit of financial data and not concern himself with internal management documents. The tax section also wanted to know the direction of the audit at this stage since they stated they had provided enough information to prove that both Sections 367 and 482 did not apply. They also stated that they were not providing any more information to support a fishing expedition, since most of the agent's questions did not directly apply to the domestic return. In this case, the taxpayer actually had all of the internal management documents necessary to audit the foreign subsidiaries' transactions which were relevant to the Service's examination.

6. Verifying items of income and expense on the profit and loss statement of the tax-haven subsidiary.

Each question had to be asked with a lengthy explanation of why it was necessary to have the information to verify the domestic corporation's return. The agent had to explain the issue that the information was related to, and in general had to argue the case before the facts were obtained. The taxpayer's explanation for this action is that information was not being furnished to further a fishing expedition. The examination of this case is still in process.

CURRENT TRAINING PROGRAMS IN INTERNATIONAL AREA

In an attempt to cope with this difficult enforcement problem we have developed extensive training programs designed to broaden the knowledge of agents in tax law and auditing techniques pertaining to domestic-foreign controlled transactions. Particular emphasis is placed on tax avoidance devices which have been or could be employed to divert income to foreign areas which should properly be reportable in the domestic parent's return. The enrollees in this intensified training program include GS-12 and GS-13 revenue agents as well as some reviewers, conference coordinators, conferees and group supervisors. Approximately 1,000 employees will be enrolled in the training courses during the fiscal year 1962, and the remaining GS-12 and GS-13 agents and group supervisors will

be trained during the fiscal year 1963. These specially trained agents will be assigned those returns involving foreign transactions. In addition, they will be able to draw on our regional coordinators and agents assigned to the Office of International Operations who have been more intensively trained in the examination of international transactions.

While we feel confident that the successful completion of this training course will provide the revenue agents the basic knowledges and techniques which are essential to achieving an effective examination, it will not alter the need to allocate a disproportionate amount of manpower to these cases.

(signed) Mortimer M. Caplin
Commissioner

Attachments

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EXHIBIT A

Supplemental Data on Cases Summarized in Document 5355
Involving Tax Avoidance in Foreign Activities

Case No.	Tax Years Involved	Date Return Assigned	Status of Case	Grade of Agents Det. OIO	Examination Time To Date	Examination Time Estimated Additional	Income Adjustment Based on Foreign Issues	Asset Class of Domestic Parent	Date of Incorporation Foreign Subsidiary	Dividends Distributed by Foreign Subsidiary
1	1959	8/15/60	Complete	13	297	None	22,760 404,362 427,122	10	9/56	None
2	1959 1960	10/27/61	In Process	12	28	80	21,033 13,940	9	7/9/54	None
3	1957, '58 & '59	1/22/58 11/20/59	In review	13	260 hrs	80	365,486.09	7	4/30/57	None
4	1947 1948	4/5/51	Closed			–	(Total tax 1,783,806)	–	1947	None
5	1958 1959	1/30/61	In process	13	479 hrs	240 hrs	2,593,977	10	2/54	None
6	–	–	This case is assigned at the present time as a joint investigation and details cannot be given at this time.							
7	1957 1958	3/59	Closed 11/7/60	12	600 hrs	280 hrs	139,000	9	12/28/56	None
8	'58, 59 & 60	2/13/61	In process	12	90 hrs.	210 hrs	900,000	9	9/56	None
9	1957–59	9/2/59	In Review	12	220 hrs	90 hrs	187,000	Partnership	2/7/56 6/30/60	None
10	'55, 56, 57 & 58	3/17/58 10/4/60	In Process	13 (2)	370 hrs	400 hrs	10,000,000	10	1955 1956	$174,471

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EXHIBIT A

Case No.	Tax Years Involved	Date Return Assigned	Status of Case	Grade of Agents Dst. 010	Examination Time: To Date	Examination Time: Estimated Additional	Income Adjustment Based on Foreign Issues	Asset Class of Domestic Parent	Date of Incorporation Foreign Subsidiary	Dividends Distributed by Foreign Subsidiary
11	1959	2/27/61	Closed to App. Div.	13	177 hrs		$280,771	10	1/5/11 4/21/54 4/12/16 1/16/56 3/12/53 3/26/59	(18 Subs distributed $2,917,660)
12	FY 1959	2/1/61	In process	13	120 hrs		500,000	10	(13 subs at issue) 3/1/58	22,388
13	FY 3/31/58	6/26/59	Closed to App Div.	12	172 hrs		210,534.01	9	8/27/42 7/1/56	None
14	1959 1960	2/15/61	Closed	13	46 hrs		5,357	4	2/23/59	None
15	1959	2/6/61	Closed 5/8/61	12	26 hrs		None	7	1957	None
16	'58, 59 & 60	6/9/60	Pending	12		2375 hrs	Unknown	9-10	(8 subs 1950 thru 1960)	None
17	'50, 51, 52 53, 54, 55 & 56	3/21/56	Closed 12/31/61	13	1,198 hrs		2,821,068	9	Not known	None
18	'56, 57, 58 & 59	11/29/60	Closed	13	137 hrs	64 hrs	35,000	9	1957	None
19	'57, 58 & 59	9/2/59 to 1/4/62	Closed	12	792 hrs	-	1,762,616	9	1956, 58 & 59	$3,680,962
20	1944 - 1948	9/25/48	Closed	13	-	-	(Tax & penalties $3,200,931)	-	-	-

EXHIBIT A

Case No.	Tax Years Involved	Date Return Assigned	Status of Case	Grade of Agents Dst. OIO	Examination Time: To Date	Examination Time: Estimated Additional	Income Adjustment Based on Foreign Issues	Asset Class of Domestic Parent	Date of Incorporation Foreign Subsidiary	Dividends Distributed by Foreign Subsidiary
21	'58, 59 & 60	3/31/60	In process	12		200 hrs	$ 10,500	6	1949	None
22	1959 1960	9/7/60	In process	12	400 hrs		2,000,000	10	12/8/58	None
23	'56, 58 & 59	9/12/60	In process	11	80 hrs	48	40,700	6 & 7	5/58	None
24	1955-60	10/60	In process	13	1360 hrs	200 hrs	1,102,000	11	1/1/57 (13 others various dates)	$428,982
25	1959	4/14/61	In process	13	40 hrs	120 hrs	272,000	9	2/12/58	None
26	'56, 57, 58 & 59	2/58 11/60	In process	13	1248 hrs	320 hrs	35,000	11	8/19/58	$4,624,814
27	1957 & '58	10/7/60	Closed	12	508 hrs		None on foreign issue	None	Prior to 1954	$5,721.64
28	1957 & '58	11/6/59	Closed	13	40 hrs		100,127	10	8/9/57	None
29	'57, 58 & 59	2/4/58	Closed 3/18/60	12	228 hrs		300,000	5	4/55	None
30	1958 1959	7/60	In process	13	496 hrs	80 hrs	100,000	10	1898 - 1958	2,660,881

EXHIBIT A

Case No.	Tax Years Involved	Date Return Assigned	Status of Case	Grade of Agents Dst. OIO	Examination Time To Date	Examination Time Estimated Additional	Income Adjustment Based on Foreign Issues	Asset Class of Domestic Parent	Date of Incorporation Foreign Subsidiary	Dividends Distributed by Foreign Subsidiary
31	*58 – 60	7/20/60	In process	13	602 hrs	300 hrs	$1,639,000	9	1958, 59 & 60	$500,000
32	*55 – 58	3/27/57 to 1/19/61	In process	13	1104 hrs	1200 hrs	15,021,933	11	8/1/50, 11/12/55 5/24/56, 5/15/57 6/15/57, 6/10/60	34,316
33	1959	This is a foreign corporation which receives capital from U. S. investors and is beyond the reach of U. S. tax laws.								
34	1959	Same as Case #33								
35	1959	Same as Case #33								
36	1946 – 1957		Closed	13	592 hrs		Taxpayer was taxed as a resident foreign corporation.			
37	*58, 59 & 60	1/13/61	In process	13	47 hrs	24 hrs	500,000	8	Unknown	None
38	*57, 58, 59 & 60	4/13/60	In process	13	35 hrs	54 hrs	Unknown	11	4/5/57	None
39	1960	10/24/61	Not stated	13	Unknown	Unknown	Unknown	8	10/15/59	$5,851.

EXHIBIT B

Estimated Man-Year Requirements

To Examine Returns Involving International Transactions

July 1, 1961
Available Resources

	Total Positions	Examining Agent Positions 1/
GS-13	1611	555
GS-12	1916	1296
Total	3527	1851
Percent Examination Time		x 85%
Examination Man-Years Available		1573

Requirements to Examine Returns Involving International Transactions

Number of Returns 2/	3,044
Man-Days per Return	x 24
Man-Day Requirements	73,056
	x 8
Man-Hour Requirements	584,448
Man-Year Requirements (584,448 ÷ 2024) 3/	289
Percent of Total Requirements to Available Resources (289 ÷ 1573)	18 percent

1/ Excludes:
Chiefs and Assistant Chiefs
Regional Analysts
Group Supervisors
Conference Coordinators
Conferees
Classifying Officers
Engineers
Estate and Gift Tax Agents
Excise Tax Agents
Fraud Agents
Offer-in-Compromise Agents
Reviewers (including Pension Trust)

2/ This total involves only those returns identified as of January 1, 1962.

3/ 2024 equals man-hours per man-year.

E. Separate Limitation on Foreign Tax Credit with Respect to Investment Income

Existing law limits the amount of foreign income tax that a taxpayer can credit against his United States tax. The limitation either is computed separately with respect to each foreign country and possession of the United States, or, at the taxpayer's election, is computed with respect to all foreign countries and United States possessions together.

In substance, the limitation provides that the credit cannot exceed the taxpayer's average United States tax rate multiplied by his taxable income for the particular country or possession or his total foreign taxable income (depending upon which method is elected). Consequently, where the average foreign tax rate exceeds the average United States rate, credit cannot be claimed for a portion of the foreign taxes.

The limitations formula, as presently drawn, however, does allow full credit for foreign taxes exceeding the United States average rate where taxpayers also obtain sufficient other foreign income which is subject to a low rate of tax abroad. In other words, if foreign tax on business income is imposed at a high rate and on interest income at a lower rate, the two taxes are combined and the aggregate average foreign tax rate is somewhere between the two specific rates.

For example, a United States corporation doing business in Canada through a branch might be subjected to a combined Canadian tax of 57-1/2 percent consisting of the normal 50 percent Canadian corporate rate plus a branch profits tax of 15 percent on its remaining income (if not reinvested in certain assets in Canada). If the corporation had $50,000 of Canadian business income, and was subjected to a tax of $28,750 by Canada (57-1/2 percent of $50,000) it would be allowed a credit by the United States of only $26,000 (52 percent of $50,000). This would leave the corporation with an unused foreign tax credit in the amount of $2,750. However, to avoid this result, the taxpayer might transfer sufficient of its funds invested in the United States to bank accounts or investments in Canada to produce $7,500 of investment income. Assuming that this investment income was subjected to only a 15 percent withholding tax by Canada, the corporation would pay a Canadian tax on this investment income of $1,125. Its total Canadian taxes now would be $29,875 which is only slightly less than $29,900 (52 percent of its total Canadian income, $57,500). Accordingly, under present law the corporation would be allowed full credit for all of its Canadian tax payments. Similarly full credit would also be allowable if the investment income had been obtained from a

different foreign country also imposing a 15 percent withholding tax provided that the overall limitation (rather than the per-country limitation) had been elected by the taxpayer.

In this example, the effect of allowing use of the unused credit of $2,750 would be to raise the corporation's after-tax return on the $7,500 of investment income from $3,600 ($7,500 less 52 percent of $7,500) to $6,350 ($7,500 less the Canadian withholding tax of $1,125 less additional U. S. tax of $25). Thus, under the circumstances the credit mechanism would provide a strong artificial incentive for the corporation in this example to transfer short-term investment funds from the United States to Canada.

The proposed amendment to the foreign tax credit provisions requires that the limitation on the foreign tax credit for foreign investment income be computed separately from the limitation for other foreign income, whether the limitations are computed on a per-country basis or on the overall basis. Foreign investment income is defined to include only interest income from sources outside the United States and dividend income from sources outside the United States other than dividends received by United States corporate taxpayers owning 10 percent or more of the foreign corporation distributing the dividend. It is believed that these are the principal forms of foreign investment income obtained by taxpayers in response to the above-described tax incentive. Application of the proposed amendment in the preceding example would permit full credit for the $1,125 tax in respect to the $7,500 of Canadian investment income but would not allow the taxpayer to use the $2,750 excess credit arising out of its business income to be applied against the U. S. tax on the investment income.

The enactment of this proposal would remove an unwarranted stimulus now provided by the foreign tax credit provisions to the flow of short-term capital abroad and thus would have a favorable stabilizing impact on this country's balance of payments.

<u>Statutory Language to Implement Separate Limitation on Foreign Tax Credit with Respect to Investment Income</u>

(a) Section 904 (relating to limitations on the foreign tax credit) is amended--

(1) By redesignating subsection (f) thereof, relating to a cross reference, as subsection (g), and

(2) By adding after subsection (e) thereof a new subsection (f) as follows:

"(f) Special rules in case of investment income.--

"(1) In general.--In the case of a taxpayer who has foreign investment income as defined in paragraph (3), this section shall, as provided in paragraph (2), apply separately with respect to--

."(A) Such income, and

"(B) Other taxable income from sources without the United States.

"(2) Application of per-country or overall limitation.--

"(A) In a case where the limitation provided in subsection (a) (1) applies, such limitation shall be applied separately to the foreign investment income from sources within each foreign country or possession of the United States and to all other taxable income from sources within such country or possession, but in each case both types of income shall be included in determining the taxpayer's entire taxable income. In making any computation or determination of taxes paid or accrued to a foreign country or possession of the United States, such taxes shall be divided between those paid or accrued with respect to foreign investment income and those paid or accrued with respect to all other income from sources within the foreign country or possession of the United States.

"(B) In a case where the limitation provided in subsection (a) (2) applies, such limitation shall be applied separately to the total of foreign investment income and to the total of all other income from sources without the United States, but in each case both types of income shall be included in determining the taxpayer's entire taxable income. In making any computation or determination of taxes paid or accrued to all foreign countries and possessions of the United States, such taxes shall be divided between those paid or accrued with respect to the total foreign investment income and those paid or accrued with respect to the total of all other taxable income from sources without the United States.

"(3) Foreign investment income.--As used in this subsection, 'foreign investment income' means the taxable income from interest and dividends (other than dividends received by a domestic corporation from a foreign corporation in which it owns at least 10 percent of the voting stock), but only to the extent constituting taxable income from sources without the United States.

"(4) Transitional rules for carrybacks and carryovers.--

"(A) Where under the provisions of subsection (d) foreign taxes paid or accrued in any taxable year to which this subsection applies are deemed paid or accrued in one or more taxable years preceding the first taxable year to which this subsection applies, any excess foreign taxes which are separately determined solely by reason of the application of this subsection shall be combined (as if this subsection had not been enacted) but only for the purpose of determining the amount of taxes deemed paid or accrued in such preceding taxable years. To the extent such excess is not, under the preceding sentence, deemed taxes paid or accrued in such preceding taxable years, such excess (in the other years for which under subsection (d) it is deemed taxes paid or accrued) shall be deemed paid or accrued with respect to foreign investment income and with respect to other taxable income from sources without the United States in the same ratio as the excess foreign taxes so separately determined bears to the excess taxes as so combined.

"(B) In determining under the provisions of subsection (d), the taxes paid or accrued in any taxable year preceding the first taxable year to which this subsection applies which are to be deemed paid or accrued in any taxable year to which this subsection applies, the excess taxes for such prior taxable year shall be deemed to be excess taxes with respect to foreign investment income in the ratio that the taxes paid or accrued, in the taxable year to which this subsection applies, with respect to foreign investment income bears to sum of such taxes and the taxes paid with respect to other taxable income from sources without the United States, and shall be deemed to be excess taxes with respect to other taxable income from sources without the United States in the ratio that the taxes paid or accrued, in the taxable year to which this subsection applies, with respect to other taxable

income from sources without the United States bears to sum of such taxes and taxes paid or accrued with respect to foreign investment income; and shall be deemed taxes paid or accrued in the taxable year to which this subsection applies to the extent provided in subsection (d)."

(b) The amendments made by this section shall be applicable with respect to taxable years beginning after the date of the enactment of this Act.

F. Foreign Investment Companies

This memorandum summarizes data available on foreign investment companies. The memorandum is based on material made available by the Securities and Exchange Commission, including financial reports filed by the companies. The prospectuses of some of the companies, and Canadian balance-of-payments data pertaining to the Canadian companies, have also been examined.

1. Number of Companies

There are fourteen foreign investment companies registered with the Securities and Exchange Commission: 10 Canadian, three Bermudian, and one South African. A list of these companies is attached (Table 1).

The first Canadian company began operations in 1954, the South African company began in 1958, and the first Bermudian company in 1960. The second Bermudian company began operations in 1961 with the sale of $23 million of stock. A third Bermudian company, registered as an investment company in September, 1961, has a registration pending with the Securities and Exchange Commission for the issuance of an initial $10 million of capital stock. One small Canadian company was liquidated during the past year.

2. Method of Operation

The foreign investment companies generally invest only outside the United States so that they have no business in or income from the United States. They generally retain for reinvestment their investment income as well as gains realized from the sale of portfolio investments, and declare no cash dividends, although they may on occasion declare stock dividends. Except for the South African company and one of the Bermudian companies, the companies are open-end; their shares are sold at net asset value (plus a sales commission in most cases) and redeemed at net asset value.

The South African company (closed-end) is believed to be the only foreign investment company which has paid cash dividends. This company holds the bulk of its net assets in the form of shares of South African gold mining companies, a number of which also produce uranium.

The Canadian companies have invested primarily in Canada during most of the period; there has recently been a tendency to shift some of their investments toward other areas, principally Western Europe. Canadian data indicate that at the end of 1959 the nine Canadian companies then in operation held an estimated $331 million in Canadian securities and about $43 million of non-Canadian securities, most of which were European. The

Bermudian companies appear to be oriented largely toward Western Europe, although investment in other areas, such as British Commonwealth countries and Japan, is not ruled out.

3. Capital Flows

Information provided by the SEC indicates that (up to latest available dates in 1961) total stock sales and redemptions were approximately as follows (in millions of dollars):

	Total	Ten Canadian Companies	One South African Company	Two Bermudian Companies
Sales of capital stock	553	484	31	38
Redemptions of capital stock	254	254	-	-
Net proceeds	299	230	31	38

Not all of these transactions were with U. S. investors. In the case of Canada, it may be assumed that at least 95% were with non-Canadians, in view of the provisions of Canadian tax law regarding Canadian tax treatment. Data from Canadian sources suggest that U. S. ownership of the Canadian funds was somewhat above 95% at the end of 1959. No similar basis for estimating the proportion of U. S. ownership of the South African and Bermudian companies has been found.

A time series on sales and redemptions of capital stock of the foreign investment companies is presented in Table 2. This series is based on an analysis of quarterly data within the fiscal years of these companies; the data do not in all cases coincide precisely with calendar years. The data indicate that there was a net redemption of the shares of the Canadian companies amounting to $94 million during 1959-1961, in contrast to 1954-1957, when there were large net sales.

4. Earnings

The foreign investment companies typically do not distribute income. Accumulated investment income and appreciation of investments enter into net asset value applicable to outstanding shares, so that the redemption of shares involves an element of investment income.

An analysis of annual investment income and annual changes in the undistributed net investment income of the foreign investment companies is contained in Table 3. For the Canadian companies, the difference between net income and changes in undistributed net income is considered to represent the amount of investment income distributed in connection with share redemption. In the case of the South African company these figures represent cash dividends paid.

5. Net Assets

The available data on the net amounts of the foreign investment companies (as of the latest available dates in 1961) have been summarized in Table 4.

January 12, 1962

Attachments

Table 1 - LIST OF REGISTERED FOREIGN INVESTMENT COMPANIES

Name 1/	Net Assets	As of	Date Commission Granted Order Permitting Registration
American-South African Investment Company, Ltd. (South Africa)	$37,544,232	6/31/61	8/13/58
Canada General Fund (1954) Ltd.	73,766,842	8/31/61	8/16/58
Canadian International Growth Fund, Ltd.	12,006,584	6/30/61	7/ 6/56
Electronics International Capital Ltd. (Bermuda)	14,709,811	6/30/61	9/16/60
Investors Group Canadian Fund, Ltd.	112,315,051	6/30/61	3/30/55
Keystone Fund of Canada Ltd.	17,130,420	3/31/61	8/18/54
Loomis-Sayles Fund of Canada Ltd.	20,838,561	6/30/61	7/ 6/59
New York Capital Fund, Ltd.	31,470,255	6/30/61	8/11/54
Scudder Fund of Canada Ltd.	56,965,437	3/31/60	4/27/54
Axe Templeton Growth Fund of Canada Ltd.	6,641,366	10/31/61	10/ 7/54
UDS Fund of Canada, Ltd.	3,486,560	6/30/61	4/ 1/60
United Funds Canada Ltd.	15,751,773	6/30/61	8/ 4/54
United International Fund Ltd. (Bermuda)	22,893,747	4/30/61	3/ 9/60
World Wide Fund Ltd. (Bermuda)	(10,000,000 proposed)		9/18/61

1/ Unless otherwise indicated, all companies are incorporated in Canada.

January 12, 1962

Table 2.- Sales and Redemptions of Capital Stock of Foreign Investment Companies

(In millions of dollars)

Calendar Year 1/	Total Thirteen Companies			Ten Canadian Companies			One South African and Two Bermudian Companies		
	Sales	Redemptions	Net Proceeds	Sales	Redemptions	Net Proceeds	Sales	Redemptions	Net Proceeds
1954..........	124	*	124	124	*	124			
1955..........	83	15	68	83	15	68			
1956..........	80	19	61	80	19	61			
1957..........	85	21	64	85	21	64			
1958..........	68	31	37	37	31	7	31 3/	-	31 3/
1959..........	51	64	-12	51	64	-12			
1960..........	31	52	-21	16	52	-36	15 4/	-	15 4/
1961 (to latest available dates 2/)	30	53	-23	7	53	-46	23 4/	-	23 4/
Total....	553	254	299	484	254	230	69	-	69

1/ Data for four companies are included on basis of fiscal quarters ending closest to end of the calendar year.

2/ Data are available only through a portion of 1961 (ranging from June 30 to October 31).

3/ South African company.

4/ Bermudian companies.

* Less than $500,000.

Note: Detail may not add to totals because of rounding.

Source: Based on material made available by the Securities and Exchange Commission.

January 12, 1962

Table 3. Analysis of Net Investment Income of Foreign Investment Companies 1/
(In Millions of dollars)

Year 2/	Ten Canadian Companies				One South African Company			
	Net Investment Income	Undistributed Net Inv. Income: Accumulated Year-End Amount	Undistributed Net Inv. Income: Annual Change	Imputed Income Distribution 3/	Net Investment Income	Undistributed Net Inv. Income: Accumulated Year-End Amount	Undistributed Net Inv. Income: Annual Change	Income Distribution 4/
1954	.9	.9	.9	*				
1955	4.0	4.7	3.7	.3				
1956	5.8	9.8	5.1	.7				
1957	7.6	15.8	6.0	1.6				
1958	8.1	22.4	6.6	1.5	.6	.6	.6	-
1959	8.0	27.6	5.1	2.9	1.6	1.8	1.1	.5
1960	7.0	31.3	3.7	3.3	1.9	3.1	1.4	.5
1961 (to latest available dates 5/)	4.4	32.1	.8	3.6	1.0	3.9	.8	.2
Total	45.8	-	32.1	13.7	5.1	-	3.9	1.2

1/ Canadian and South African companies only; income reported by the Bermudian companies has been minor.
2/ Data for five companies are included on basis of half-year ending closest to end of the calendar year.
3/ Derived by subtracting the annual change in undistributed net investment income from net investment income for the year.
4/ Cash dividends.
5/ Data are available only through a portion of 1961 (ranging from April 30 to October 31).
* Less than $50,000.
Note: Detail may not add to totals because of rounding.
Source: ...sed on material made available by the Securities ... Exchange Commission. January 12, 19

Table 4.- Sources of Net Assets of Foreign Investment Companies as of Latest Available Dates in 1961

(In millions of dollars)

	Total	Ten Canadian Companies 1/	One South African Company 2/	Two Bermudian Companies 2/
Net proceeds from sales of capital stock......	293	225	31	37
Accumulated net realized gain on investments..:	6	5	1	-
Unrealized appreciation of investments........	86	84	2	-
Total:................................	384	314	33	37
Undistributed net investment income..........	36	32	4	-
Net assets applicable to outstanding shares............................	422	346	38	39

Note: Detail may not add to totals because of rounding.

1/ Data are included as of various dates ranging from March 31 to August 30 and may not cross check with table 2 due to exchange rate changes and date differentials.

Source: Based on data made available by the Securities and Exchange Commission.

January 12, 1962

EXHIBIT IV

REPEAL OF THE DIVIDEND RECEIVED CREDIT AND EXCLUSION

Table 1 - Number of Individual Income Tax Returns with Dividends and Amount of Such Dividends in 1959

This table shows that the receipt of dividends is highly concentrated in high income groups. In 1959 only 5 percent of the taxable returns with incomes under $5,000 reported dividends and for such returns dividends amounted to less than 1 percent of income. In contrast, 96 percent of the returns with incomes between $200,000 and $500,000 reported dividends amounting to about 37 percent of the total income reported by returns in this income group.

Table 2 - Extra Burden on Stockholder, Assuming Double Taxation of Dividends (For a single dollar of corporate earnings before tax)

This table shows that the extra burden of "double taxation" per dollar of corporate earnings is greater for stockholders with low incomes than for stockholders with high incomes. The extra burden is the sum of (1) the corporate income tax on the dollar of profits, plus (2) the individual income tax on the dividends received from the profits remaining after the payment of corporate tax, minus (3) the individual income tax that would be incurred if the entire dollar of corporate profits were distributed to the individual in the absence of a corporate income tax.

Table 3 - Relief from "Double Taxation" of Dividends Provided by the 4 Percent Dividend Credit (For a single dollar of corporate earnings before tax)

This table shows that the 4 percent dividend credit removes a very substantial part of the extra burden of "double taxation" at high income levels but only a small portion of the extra burden at low income levels.

Table 4 - Relief from "Double Taxation" of Dividends Provided by a 10 Percent Dividend Credit

Table 5 - Relief from "Double Taxation" of Dividends Provided by a 15 Percent Dividend Credit

Table 6 - Relief from "Double Taxation" of Dividends Provided by a 20 Percent Dividend Credit (For a single dollar of corporate earnings before tax)

Tables 4, 5, and 6 indicate how much of the extra burden of "double taxation" would be removed for shareholders at various income levels if the present 4 percent credit were increased to 10 percent, 15 percent, or 20 percent. They show that at high income levels credits of these magnitudes would produce

tax savings exceeding the extra burden that the shareholder is presumed to bear under the double taxation concept. In other words, with credits of this size shareholders at high income levels would be in a better position than if there were no corporate income tax and the entire earnings were taxed to them directly.

Table 7 - Relief from "Double Taxation" of Dividends Provided by the $50 Exclusion
(For a single dollar of corporate earnings before tax)

This table illustrates how the absolute amount of tax reduction granted by the present $50 dividend exclusion increases with the size of the taxpayer's income. At high income levels the relief provided per dollar of dividend eligible for the exclusion exceeds the extra burden resulting from the corporate income tax.

Table 8 - Relief from "Double Taxation" of Dividends Provided by the Dividend Credit and Exclusion for Taxpayers Receiving the Average Amount of Dividends Reported at Their Income Level on 1959 Returns with Dividends
(Per dollar of pretax corporate earnings attributed to taxpayer)

This table shows the effect of the credit and exclusion on shareholders who are assumed to have the average amount of dividends reported on 1959 returns with dividends at comparable income levels. The dividend credit, given the distribution of dividends, removes a much larger percentage of the extra burden of "double taxation" at high income levels than at low income levels. Because it is limited to $50 ($100 for a married couple where each spouse has dividend income) the exclusion is more favorable than the credit to individuals with small and moderate incomes. However, the important point is that at high income levels, the combined credit and exclusion remove a very much greater part of the extra burden of "double taxation" at high income levels than at low and moderate income levels.

Table 9 - Corporate Public Long-term Financing, 1946-1961 (Excluding Banks and Insurance Companies)

This table shows that there has been no significant change in the proportion of corporate external long-term financing accounted for by stock since the adoption of the 1954 dividend provisions.

Table 1

Number of individual income tax returns with dividends and amount of dividends in 1959

Adjusted gross income	Number of returns with dividends 1/	Dividends on returns 1/	All returns	Adjusted gross income, all returns	Number of returns with dividends as a percent of all returns	Dividends on returns as a percent of adjusted gross income
		(dollar amounts in thousands)				
Taxable returns						
Under $5	1,142,168	$ 675,392	23,415,117	$ 71,434,488	4.9%	0.9%
5-10	2,008,754	1,253,645	19,305,707	133,012,206	10.4	0.9
10-20	1,369,308	1,731,510	3,909,998	49,701,599	35.0	3.5
20-50	518,881	2,219,331	723,682	20,846,984	71.7	10.6
50-100	101,520	1,416,317	114,711	7,549,453	88.5	18.8
100-200	20,492	845,098	21,940	2,844,906	93.4	29.7
200-500	4,598	508,843	4,776	1,361,923	96.3	37.4
500-1,000	700	190,677	717	478,154	97.6	39.9
1,000 and over	261	263,463	265	545,633	98.5	48.3
Nontaxable returns	781,696	610,118	12,774,384	17,319,633	6.1	3.5
Total	5,948,378	9,714,394	60,271,297	305,094,979	9.9	3.2

Treasury Department, Office of Tax Analysis

April 2, 1962

1/ Covers domestic and foreign dividends before dividend exclusions. Does not include data for Form 1040A returns which do not specify the amount of dividends received.

Table 2

Extra Burden on Stockholder, Assuming Double Taxation of Dividends

For a single dollar of corporate earnings before tax

Adjusted gross income (1)	Corporation income tax on $1 of earnings (2)	Individual income tax on 48¢ of dividends (3)	Total present tax (4) (2)+(3)	Individual income tax if corporate earnings of $1 were distributed with no corporation income tax (5)	Extra burden due to double taxation (6) (4)-(5)
$ 1,500	52¢	0¢	52¢	0¢	52¢
5,000	52	10	62	20	42
10,000	52	11	63	22	41
15,000	52	12	64	26	38
20,000	52	14	66	30	36
25,000	52	18	70	38	32
50,000	52	27	79	56	23
100,000	52	33	85	69	16
250,000	52	43	95	89	6
500,000	52	44	96	91	5
1,000,000	52	44	96	91	5

Treasury Department
Office of Tax Analysis

April 2, 1962

Note: Table assumes that the 48 cents of corporate earnings remaining after payment of the 52 percent corporate income tax are distributed and are eligible for the credit. It also assumes that the stockholder has a spouse and two children.

Table 3

Relief from "Double Taxation" of Dividends Provided by the 4 percent Dividend Credit

For a single dollar of corporate earnings before tax

Adjusted gross income (1)	Extra burden from "double taxation" of dividends (2)	Dividend credit (4% of 48¢) (3)	Extra burden after dividend credit (2) - (3)	Percent of extra burden removed by dividend credit (3) ÷ (2)
$ 1,500	52.0¢	0.0¢	52.0¢	0.0%
5,000	41.6	1.9	39.7	4.6
10,000	40.6	1.9	38.7	4.7
15,000	38.5	1.9	36.6	4.9
20,000	36.4	1.9	34.5	5.2
25,000	32.2	1.9	30.3	5.9
50,000	22.9	1.9	21.0	8.3
100,000	16.1	1.9	14.2	11.8
250,000	5.7	1.9	3.8	33.3
500,000	4.7	1.9	2.8	40.4
1,000,000	4.7	1.9	2.8	40.4

Treasury Department
Office of Tax Analysis

April 2, 1962

Note: Table assumes that the 48 cents of corporate earnings remaining after payment of the 52 percent corporate income tax are distributed and are eligible for the credit. It also assumes that the stockholder has a spouse and two children.

Table 4

Relief from "Double Taxation" of Dividends Provided by a 10 percent Dividend Credit

For a single dollar of corporate earnings before tax

Adjusted gross income (1)	Extra burden from "double taxation" of dividends (2)	Dividend credit (10% of 48¢) (3)	Extra burden after dividend credit (2) - (3)	Percent of extra burden removed by dividend credit (3) ÷ (2)
$ 1,500	52.0¢	0.0¢	52.0¢	0.0%
5,000	41.6	4.8	36.8	11.5
10,000	40.6	4.8	35.8	11.8
15,000	38.5	4.8	33.7	12.5
20,000	36.4	4.8	31.6	13.2
25,000	32.2	4.8	27.4	14.9
50,000	22.9	4.8	18.1	21.0
100,000	16.1	4.8	11.3	29.8
250,000	5.7	4.8	.9	84.2
500,000	4.7	4.8	-.1 a/	102.1 a/
1,000,000	4.7	4.8	-.1 a/	102.1 a/

Treasury Department
Office of Tax Analysis

April 2, 1962

Note: Table assumes that the 48 cents of corporate earnings remaining after payment of the 52 percent corporate income tax are distributed and are eligible for the credit. It also assumes that the stockholder has a spouse and two children.

a/Extra burden converted to tax savings.

Table 5

Relief from "Double Taxation" of Dividends Provided by a 15 percent Dividend Credit

For a single dollar of corporate earnings before tax

Adjusted gross income (1)	Extra burden from "double taxation" of dividends (2)	Dividend credit (15% of 48¢) (3)	Extra burden after dividend credit (2) - (3)	Percent of extra burden removed by dividend credit (3) ÷ (2)
$ 1,500	52.0¢	0.0¢	52.0¢	0.0%
5,000	41.6	7.2	34.4	17.3
10,000	40.6	7.2	33.4	17.7
15,000	38.5	7.2	31.3	18.7
20,000	36.4	7.2	29.2	19.8
25,000	32.2	7.2	25.0	22.4
50,000	22.9	7.2	15.7	31.4
100,000	16.1	7.2	8.9	44.7
250,000	5.7	7.2	-1.5 a/	126.3 a/
500,000	4.7	7.2	-2.5 a/	153.2 a/
1,000,000	4.7	7.2	-2.5 a/	153.2 a/

Treasury Department
Office of Tax Analysis

April 2, 1962

Note: Table assumes that the 48 cents of corporate earnings remaining after payment of the 52 percent corporate income tax are distributed and are eligible for the credit. It also assumes that the stockholder has a spouse and two children.

a/Extra burden converted to tax savings.

Table 6

Relief from "Double Taxation" of Dividends Provided by a 20 percent Dividend Credit

For a single dollar of corporate earnings before tax

Adjusted gross income (1)	Extra burden from "double taxation" of dividends (2)	Dividend credit (20% of 48¢) (3)	Extra burden after dividend credit (2) - (3)	Percent of extra burden removed by dividend credit (3) ÷ (2)
$ 1,500	52.0¢	0.0¢	52.0¢	0.0%
5,000	41.6	9.6	32.0	23.1
10,000	40.6	9.6	31.0	23.6
15,000	38.5	9.6	28.9	24.9
20,000	36.4	9.6	26.8	26.4
25,000	32.2	9.6	22.6	29.8
50,000	22.9	9.6	13.3	41.9
100,000	16.1	9.6	6.5	59.6
250,000	5.7	9.6	-3.9 a/	168.4 a/
500,000	4.7	9.6	-4.9 a/	204.3 a/
1,000,000	4.7	9.6	-4.9 a/	204.3 a/

Treasury Department, Office of Tax Analysis April 2, 1962

Note: Table assumes that the 48 cents of corporate earnings remaining after payment of the 52 percent corporate income tax are distributed and are eligible for the credit. It also assumes that the stockholder has a spouse and two children.

a/ Extra burden converted to tax savings.

Table 7

Relief from "Double Taxation" of Dividends Provided by the $50 Exclusion

For a single dollar of corporate earnings before tax

Adjusted gross income (1)	Extra burden from "double taxation" of dividends (2)	Reduction under exclusion (3)	Extra burden after exclusion (2) - (3)	Percent of extra burden removed by exclusion (3) ÷ (2)
$ 1,500	52¢	0¢	52¢	0.0%
3,000	42	10	32	23.8
5,000	42	10	32	23.8
10,000	41	11	30	26.8
15,000	38	12	26	31.6
20,000	36	14	22	38.9
25,000	32	18	14	56.2
50,000	23	27	-4 a/	117.4 a/
100,000	16	33	-17 a/	206.2 a/
250,000	6	43	-37 a/	716.7 a/
500,000	5	44	-39 a/	880.0 a/
1,000,000	5	44	-39 a/	880.0 a/

Office of the Secretary of the Treasury
Office of Tax Analysis

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Note: Table assumes the 48 cents of corporate earnings remaining after payment of the 52 percent corporate income tax are distributed and are eligible for the exclusion. It also assumes that the stockholder has a spouse and two children.

a/ Extra burden converted to tax savings.

Table 8

Relief from "Double Taxation" of Dividends Provided by the Dividend Credit and Exclusion for Taxpayers Receiving the Average Amount of Dividends Reported at Their Income Level on Taxable 1959 Returns with Dividends

Per dollar of pretax corporate earnings attributed to taxpayer

Adjusted gross income (1)	Extra burden from "double taxation" of dividends (2)	Tax reduction			Percent of extra burden removed by b/		
		Exclusion (3)	Dividend credit a/ (4)	Combined credit and exclusion (5) (3) + (4)	Exclusion (3) ÷ (2)	Dividend credit a/ (4) ÷ (2)	Combined credit and exclusion (5) ÷ (2)
$ 1,500	52.0¢	0.0¢	0.0¢	0.0¢	0.0%	0.0%	0.0%
5,000	41.6	1.6	1.6	3.2	3.8	3.8	7.7
10,000	40.6	1.3	1.7	3.0	3.2	4.1	7.3
15,000	38.5	0.8	1.8	2.6	2.2	4.7	6.9
20,000	36.4	0.6	1.8	2.4	1.7	5.0	6.7
25,000	29.6	0.6	1.9	2.5	2.2	6.3	8.5
50,000	22.9	0.3	1.9	2.2	1.5	8.3	9.8
100,000	16.1	0.1	1.9	2.0	0.8	11.9	12.7
250,000	5.7	0.1	1.9	2.0	0.9	33.5	34.5
500,000	4.7	*	1.9	1.9	0.6	41.0	41.6
1,000,000	4.7	*	1.9	1.9	0.2	41.0	41.2

Office of the Secretary of the Treasury
Office of Tax Analysis

April 2, 1962

a/ Credit computed on dividends remaining after exclusion.
b/ Last three columns were computed from unrounded data and differ slightly from quotients derived by dividing table data.
Note: Figures for columns (2), (3), (4), and (5) represent the respective dollar totals for each of these columns divided by the amount of corporate earnings attributed to the stockholder at each income level on the basis of the average dividends received at that level by returns with dividends. Table assumes corporate earnings are for distribution. Computations are based on the tax liabilities of a married couple with two dependents.
*Less than .1 of a cent.

Table 9

Corporate Public Long-term Financing, 1946-1961 (Excluding Banks and Insurance Companies)

Year	Stocks	Bonds and other long-term debt 1/	Total	Stocks	Bonds and other long-term debt 1/	Total
	In billions of dollars			Percent of total		
1946	$1.3	$2.9	$4.2	31%	69%	100%
1947	1.4	4.9	6.3	22	78	100
1948	1.2	6.0	7.2	17	83	100
1949	1.6	2.7	4.3	37	63	100
1950	1.7	2.5	4.2	40	60	100
1951	2.7	5.1	7.8	35	65	100
1952	3.0	6.4	9.4	32	68	100
1953	2.3	5.3	7.6	30	70	100
1954	2.1	4.3	6.4	33	67	100
1955	2.7	5.9	8.6	31	69	100
1956	3.2	7.9	11.1	29	71	100
1957	3.5	8.4	11.9	29	71	100
1958	3.6	7.4	11.0	33	67	100
1959	3.7	5.8	9.5	39	61	100
1960	3.0	6.6	9.6	31	69	100
1961	4.9	6.0	10.9	45	55	100

Source: U. S. Department of Commerce and Securities and Exchange Commission

April 2, 1962

1/ Includes debt with a maturity over a year.

EXHIBIT V

STUDY ON ENTERTAINMENT EXPENSES

TREASURY DEPARTMENT

APRIL 1962

EXHIBIT V - EXPENSES FOR ENTERTAINMENT, TRAVEL AND BUSINESS GIFTS

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PART THREE -- Analysis of some court decisions and administrative cases allowing deductions of entertainment and related expenses. These cases illustrate that these expenditures are fully deductible under present law if some slight business association with the making of the expenditure is shown.

PART FOUR -- Compliation of current comments in newspapers and periodicals relating to expense accounts and business Gifts. These editorial comments give some indication of the public concern with the problems created by the present deductibility of entertainment of related expense.

EXPENSES FOR TRAVEL, ENTERTAINMENT, AND BUSINESS GIFTS

- PART ONE -

Audit Results of the Simultaneous Examination of 1959 and 1960 Returns with Respect to Travel and Entertainment Expenses

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RESULTS OF THE SIMULTANEOUS EXAMINATION OF 1959 AND 1960 RETURNS WITH RESPECT TO TRAVEL AND ENTERTAINMENT EXPENSES

Administrative Measures Initiated in 1960

The income tax returns covering the year 1960 and filed in 1961 were the first to reflect the efforts of former Commissioner of Internal Revenue Dana Latham to improve the travel and entertainment situation by administrative action. An intensive educational program was launched in 1960 whereby taxpayers were informed again of the abuses which were prevalent in the area and were exhorted to improve the picture by a higher degree of voluntary compliance with the law.

As a more tangible assist in this voluntary compliance process the Internal Revenue Service added a series of new questions to the 1960 returns. These questions, in the case of the individual income tax return, Form 1040, pertained to the taxpayer and his five highest paid employees. The questions concentrated on areas of greatest abuse, with the thought that this might deter taxpayers from excesses if it were known that such items would be highlighted on the returns. Among the questions asked were: Did you claim a deduction for expenses connected with a hunting lodge, fishing camp, resort property, pleasure boat or yacht? Did you deduct the cost of vacations for you or members of your family, or employees or members of their families? Did you claim a deduction for the attendance of members of your family or your employees' families at conventions or business meetings?

Similar questions appear on the 1960 partnership and corporate income tax returns and, in addition, these returns contain separate schedules requiring the listing of the expense account allowances provided to the 25 highest paid partners and officers. However, this need not be done with respect to partners or officers receiving less than $10,000 in salaries and expense account allowances combined.

Voluntary Compliance Program Unsuccessful

What has been the effect of this renewed effort at solving the expense account problem under the existing law? A study of the returns of 1,005 "business" taxpayers claiming deductions for travel and entertainment expenses, selected at random, involving simultaneous audits for the years 1959 and 1960 indicate that, as has

repeatedly been the experience in the past, 1/ the solution to the problem cannot be accomplished by administrative means. 2/ A study was made of income tax returns for 1959 and 1960 which were being audited at the same time in order to remove the effect which an immediately prior audit may have had upon the filing of the 1960 return. The following conclusions were reached:

After auditing the 1960 returns revenue agents recommended reduction in the amount claimed for travel and entertainment in 802 out of the 1,005 returns involved. Thus, despite all the publicity, educational efforts and questionnaires on the returns, over 79 percent of the returns erroneously claimed entertainment deductions. Perhaps even more significant is the fact that in 1959 this same group of 1,005 taxpayers had erroneously claimed such deductions on 811 returns, i.e., in 80 percent of the cases. In other words, no improvement was shown in the number of erroneous returns filed.

Furthermore, over one-half of the individual taxpayers did not complete the expense account schedules or answer the questionnaires on the 1960 tax return forms. Over 20 percent of the corporate taxpayers failed to comply with this requirement.

The foregoing resulted even though about 80 of the taxpayers covered by the study indicated they were aware of the publicity program of the Internal Revenue Service.

1/ Commissioner Caplin described past administrative efforts in a speech last year before the University of Chicago Tax Conference. His description is set forth as the last portion of this discussion.

2/ Furthermore, as illustrated by Part Three of this Study on Entertainment Expenses and as discussed briefly below, even if the educational and other administrative devices utilized by the Commissioner were completely effective the basic problem involving entertainment expenses would remain unsolved because present law permits the deduction of what are essentially personal items benefit.

Even 100 Percent Compliance With Existing Law Would Not Solve The Expense Account Problem

Better compliance with and enforcement of the present law relating to travel and entertainment expenses will not remedy the fundamental weakness which the deductibility of these expenses creates in our self-assessing tax system. This is so because of the unique character of these particular "business" expenses. Unlike other business expenditures, expense account items always confer substantial tax-free personal benefits in the form of entertainment, amusement, or recreation either upon the person being entertained, the one doing the entertaining, or both. It is because of this characteristic that the expense account deduction has gradually grown into one which is much abused and one, even where the business connection is clear, which has become a great source of resentment on the part of the great bulk of our taxpayers who do not participate in the benefits of this deduction but who, nevertheless, must help to provide those benefits. The keystone of the success of our self-assessing tax system is the respect which the taxpayers have for the fairness of the system. Continuation of the expense account deduction threatens to undermine that respect.

As stated by President Kennedy in his tax message of April 20, 1961: "Too many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government. Indeed, expense account living has become a by-word in the American scene." The President went on to point out that "This is a matter of national concern, affecting not only our public revenues, our sense of fairness and our respect for the tax system, but our moral and business practices as well." He pointed out that this was all largely a creature of the tax system and emphasized that tighter enforcement of present legislation would not suffice to cure it.

This is the nub of the Treasury's basic position. Essentially, items which confer substantial tax-free personal benefits to the recipients at the expense of the great bulk of taxpayers who are not privileged to participate in the expense account operation should as a matter of sound tax policy be eliminated for the long run welfare of our self-assessing tax system. As Commissioner Caplin said in his report of March 14, 1961, part two, Exhibit V to Secretary Dillon's statement before the House Ways and Means Committee: "Perhaps the most important feature in our relations with taxpayers concerns those who have no opportunity to claim T & E or other business expenses. Many newspapers and magazines have published articles which have caused a large number of taxpayers to become incensed at the apparent

inequities in the administration of the tax laws. There is evidence in our recent T & E study that these articles may have motivated some taxpayers to claim T & E expenses which they did not actually incur. While we do not feel that this situation is widespread at this time, any breakdown in voluntary compliance is viewed with extreme concern since the very foundation of our tax system is built on this principle." The Commissioner further stated: "In view of the personal nature of T & E expenses, it is impossible to accurately delineate between business and non-business expenses. Each decision must necessarily be arbitrary to some extent. Although tax administrators have been faced with this problem for more than 40 years, no solution has been advanced to resolve it on an equitable and sound basis."

Specific case studies showing that a very slight business element is sufficient to require a revenue agent under present law to allow the deduction of an essentially personal expenditure are set forth in Part Three of this study on entertainment expenses.

Portion of Commissioner Caplin's Speech on October 25, 1961, Before the University of Chicago Law School Tax Conference Presenting a Historical Survey of the Failure of Administrative Devices to Solve the Expense Account Problem:

Tax treatment of travel and entertainment expenses ("T & E") has long plagued the tax world and has inspired a host of suggested remedies by numerous commentators. The true depth of the problem was recently plumbed at the Committee on Ways and Means Hearings on the President's current proposals for legislative remedy and it is anticipated that further debate will ensue during the second session of the 87th Congress.

Why is the T & E problem so significant? The essential reason is that experience discloses widespread abuse of the tax law in this area -- abuse which strikes at the heart of our self-assessment tax system -- with no satisfactory administrative solution apparent.

Dissatisfaction over the T & E problem is not new. 1/ Remedial efforts of past Commissioners have been widely commented upon, and extended discussion of them would merely repeat what has been thoroughly stated before. 2/ Nevertheless, to put the issues in better focus, it is helpful to review the highlights of the past while emphasizing some of the more current developments.

Ante 1952.

The general T & E problem first manifested itself significantly during World War II and the period following. Prior consideration related primarily to the question of travel expenses and per diem allowances. 3/

1952.

Almost 10 years ago, in February 1952, Commissioner John B. Dunlap expressed concern over lavish travel and entertainment items claimed as tax deductions, and announced that revenue agents were being instructed to examine carefully items on returns involving T & E expenses, executive expense allowances, business gifts and similar items. 4/ Top administrative officials at that time believed that corrective legislation was necessary. 5/

1953-1955.

Following change in administration, T. Coleman Andrews, Commissioner Dunlap's successor, although expressing substantial concern over T & E, believed that pending legislative proposals were not necessary and stated that the problem could be remedied by administrative action. A broad public information program was instituted, stressing that revenue agents had been alerted to investigate T & E abuse cases. In 1954 he issued Revenue Ruling 54-195 6/, which emphasized the Service's awareness of T & E abuses and outlined guides to be used by revenue agents in determining the allowability of T & E deductions. The ruling constituted the first official recognition of the Cohan doctrine, 7/ but emphasized the need of secondary evidence at least to substantiate a claimed deduction. For example, a taxpayer who claimed travel expenses would not be entitled to a deduction, even applying Cohan, unless he produced evidence showing he was on business travel status for a certain number of days at a certain location. The allowable amount of the deduction could then be calculated through resort to known train or plane fares and comparable hotel prices.

1955-1958.

Commissioner Russell C. Harrington attempted to improve on the administrative solution by emphasizing the need for record substantiation by employees on expense account or allowance arrangements. The line 6 (a) addition to Form 1040 was announced in November of 1957. It would have required taxpayers first to include expense account allowances or reimbursements in gross income and then claim offsetting deductions on line 6 (a) for T & E expenses.

For many years Treasury regulations have required full reporting of expense account allowances and reimbursement in income together with provision for offsetting deductions. 8/ From 1921 through 1943 a space was provided on Form 1040 for these deductions. Thereafter, the instructions accompanying the return advised the taxpayer how to report such items. Insertion of line 6 (a), accordingly, made

no substantive change in the rules. Nevertheless, heavy public protest resulted because of the alleged accounting burden imposed on taxpayers, and a short while later it was announced that line 6 (a) could be disregarded for returns filed for calendar year 1957.

The line 6 (a) proposal was thereafter dropped completely in favor of a compromise approach. Treasury regulation section 1.162-17 was issued in 1958, shifting to the employer the obligation of policing most expense account allowances. The regulation was premised on the theory that most employers maintain acceptable business practices in requiring "accounting" by employees on expense account arrangements, and adopted the concept that an employee should be required to account either to his employer or to the Government, but not to both.

The regulation provides, in essence, that an employee who is required to "account" and does "account" to his employer and who does not claim deductions in excess of allowances or reimbursements could consider the expense account arrangement as a "wash". On the other hand, if the employee (1) is not required or does not account to his employer, or (2) claims tax deductions for T & E items in excess of allowances or reimbursements, he must report all reimbursements and allowances on his return and maintain substantiating records. "Account" is defined to mean a written statement to the employer showing the business nature and amount of all the employee's expenses (including those charged through credit cards) broken down into such broad categories as "transportation", "meals and lodging while away from home overnight", "entertainment expenses", and "other business" expenses. As the equivalent to an accounting, it is further provided that the Commissioner may approve reasonable mileage and per diem allowances in lieu of requiring itemization of these expenses.

The regulation stresses, however, that:

> "The Internal Revenue Code contemplates that taxpayers keep such records as will be sufficient to enable the Commissioner to correctly determine income tax liability." 9/

In addition, Form 1040 was modified to include question boxes for identifying taxpayers who received expense account allowances or reimbursements. But the general T & E problem continued, to the increasing concern of revenue administrators.

1958-1960.

In December, 1959, after a series of conferences with representatives of business and his Advisory Group, 10/ Commissioner Dana Latham

launched his comprehensive T & E enforcement program by issuing TIR 198,[11] outlining tentative policy suggestions. His program, as announced in final form in TIR 221 [12] in April, 1960, again did not represent a change in the basic rules governing T & E deductions, but did constitute an important administrative step. Added to income tax returns were (1) an expense account schedule for certain officers, partners and highly-paid employees, and (2) a questionnaire concerning hunting lodges, yachts, apartments, conventions and similar items. Although the primary purpose of the schedule was to aid in administrative identification of T & E items, the program had the practical effect of requiring a change in taxpayer record-keeping systems. Commissioner Latham also issued Rev. Rul. 60-120, [13] which defined in greater detail the type of information required to be furnished by an employee to his employer in "accounting" for T & E expenses.

In further implementation of the TIR 221 program, a new form, L-67, was devised as a notice to a taxpayer who does not maintain adequate records. The notice calls attention to inadequate record-keeping and advises the taxpayer of minimum record-keeping requirements expected. An automatic follow-up audit system was also established covering taxpayers who had been served with form L-67. In the follow-up examination, the adequacy of the taxpayer's record-keeping is tested under a strict standard. At the same time, examining agents are instructed to grant reasonable T & E allowances when it appears that deductible expenditures were incurred. If only the amount is in question, the minimum normally incurred under the circumstances will be allowed.

Negligence Penalty.

Beginning in 1960, agents have been instructed to consider the assertion of the negligence penalty under section 6653 (a) [14] when a deficiency is attributable to a taxpayer's failure to keep records.

To recapitulate, during the last decade all Commissioners of Internal Revenue have carried out serious administrative programs attempting to check T & E abuses; but on current analysis the problem still continues unsolved.

FOOTNOTES

1. Current statutory provisions are sections 162, 212 and 262 of the 1954 Code. Essentially similar provisions first appeared in the Revenue Act of 1918, Section 214 (a) (1) and Section 215 (a).

2. *E.g.*, *Groh*, "Travel and Entertainment Expenses", 39 Taxes 253 (1961); *Reed*, "Uncle Sam v. The Expense Account", 39 Taxes 329 (1961); *Sandon*, "Guidelines for Handling the Reporting of Business Expenses and Reimbursements", 38 Taxes 972 (1960); *Perkins*, "Recommendations for Preventing Disallowances of Expenses for Travel and Entertainment", 4 Journal of Taxation 10 (1956).

3. See Reg. 33, Arts. 4 and 8; Reg. 45, Art. 292; Revenue Act of 1921, Section 214 (a).

4. Bureau of Internal Revenue, Release S-2979, February 26, 1952.

5. This was the era of investigation of administration of the internal revenue laws by a subcommittee of the Ways and Means Committee, under the Chairmanships of Congressmen King and Kean.

6. C.B. 1954-1, p. 47.

7. *Cohan* v. *Commissioner* (C.C.A. 2d 1930) 39 F. 2d 540. See *infra*, p. 28.

8. See Reg. 101, Art. 23 (a) - 2 (c); Reg. 103, Sec. 19.23 (a) - 2 (c); Reg. 111, Sec. 29.23 (a) - 2 (c); Reg. 118, Sec. 39.23 (a) - 2 (c).

9. Reg. Sec. 1.162-17 (d) (2).

10. The Commissioner's Advisory Group, composed of 12 experienced tax practitioners from the legal, accounting and teaching professions.

11. Issued Dec. 29, 1959. 1960 CCH Stand. Fed. Tax Rep. Para 6245.

12. Issued April 4, 1960. 1960 CCH Stand. Fed. Tax Rep. Para 6405.

13. C.B. 1960 - 1, p. 83.

14. I.R.C. 1954, § 6653 (a).

EXPENSES FOR TRAVEL, ENTERTAINMENT, AND BUSINESS GIFTS

- PART TWO -

Report by the Commissioner of Internal Revenue
on
Administrative Problems Under Present Law
Relating to
Deduction of Travel and Entertainment Expenses

U. S. TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE
WASHINGTON 25, D. C.

IN REPLY REFER TO
O:A

March 14, 1961

MEMORANDUM FOR: Mr. Stanley S. Surrey
Assistant Secretary Designate

SUBJECT: Problems Encountered by the Service in Administering the Present Code Provisions Relating to Deductions of Travel and Entertainment Expenses

This is in response to your request for information concerning the administrative problems of the Service in connection with travel and entertainment expenses. For the sake of clarity the following narrative has been broken down into broad problem areas.

Problems in the Examination of Returns

The problems of the Service in administering the provisions relating to entertainment and traveling expenses of Section 162 of the IRC of 1954 are twofold: (1) ascertaining the facts and (2) deciding whether the expenditures are ordinary and necessary business expenses. Although it has often been difficult to apply the concept of ordinary and necessary, the principal and most time-consuming problem the Service has in this area is to determine the facts in each case in which entertainment or travel expense is claimed.

Since entertainment expenses are normally of the type incurred by individuals in their personal life, the Service is continually required to distinguish between business and nonbusiness expenses. The significance of this factor is illustrated by the statistics we recently received in connection with our current study of T&E expenses. This study covered results of examinations of 37,933 business returns made during the period of October 1, 1960 through December 31, 1960. These statistics show of disallowances made to T&E expenses 56% involved personal expenses claimed as business expenses. The types of personal expenses deducted cover every facet of personal life, ranging from purchases of entire estates to cans of dog food and boxes of pink tissue paper. Here is a list of some of the personal expenses commonly claimed as T&E expenses:

(a) Country club and athletic club dues and charges;

(b) Travel expense of wives, children, and relatives who accompany an officer, employee, partner or proprietor on a business trip;

(c) Travel expense of a personal nature, coupled with or independent of a business trip, particularly when visits are made to resort or vacation areas or to homes of friends or relatives;

(d) Maintenance, operation or rental of automobiles, yachts, hunting lodges, fishing camps, resort properties, houses, apartments, hotel suites, etc.; and

(e) Gifts to members of the taxpayer's family.

It has been our experience that many officer-stockholders of closely-held corporations claim personal expenditures as business expense. The beneficiaries of these expenditures are usually those in management and the incentive is greater since the corporate tax liability as well as the individual tax liability can be reduced by this action.

It is difficult to obtain receipts for payment of many items of entertainment and travel expenses. As a consequence, taxpayers resort to estimates or keep diaries and there is usually no practical way to make a judgment as to the credibility of items claimed either as to amount or business purpose. In many cases the only information available are checks made out to cash or book entries of flat dollar amounts supported by vague and inconclusive oral statements. In those cases where the taxpayer's business activities are such that he would be expected to incur some T&E expenses the courts have consistently applied the so-called Cohan rule. In view of this, the Service has also widely applied this doctrine. There is, however, no satisfactory standard which the revenue agent can employ; consequently, his judgment as to the correct amount of deductions frequently differs from that of the taxpayer. This not only causes considerable controversies, at the examining officer level, but gives rise to the charge that the agent is questioning the taxpayer's integrity. These examinations are time-consuming for both taxpayer and the Service, and tend to create a poor public image of the Service.

The rule in the Cohan case, while basically equitable, has caused a great deal of administrative problems. Although in theory the taxpayer must bear the burden of proving deductions, in actual practice, under the Cohan rule, the revenue agent, in examining a return of a taxpayer who has estimated his entertainment expenses or whose records are incomplete, must

reconstruct the allowable expenses through the use of secondary sources of information or collateral evidence. Revenue Ruling 54-195 sets forth methods and techniques to be used in reconstructing business expenses. We have been able to reconstruct travel expenses, although the procedure is time-consuming and is subject to considerable controversy. However, we have encountered extreme difficulties in applying this Revenue Ruling to entertainment expenses because there is no starting point or past experience that can be relied on.

Experience discloses that apparently many taxpayers who incur a nominal amount of entertainment expenses consistently take advantage of the Cohan rule by making generous estimates of entertainment expenses incurred. A typical case is that of a successful businessman who claims all the entertainment expenses he paid by check and, in addition, claims large amounts for cash entertainment. Usually in an audit of a return of this nature a part of these expenses are allowed under the Cohan rule. However, in many cases of this type the amount allowed may be in excess of what the taxpayer actually spent. This result seems to spur the taxpayer to claim a greater amount on his subsequent returns and tell his friends that the more you claim for entertainment expenses, the more you will be allowed. We have recently instituted an examination procedure in an attempt to counteract this situation. This procedure requires a follow-up after the first application of the Cohan rule so that a more strict interpretation of that rule can be applied in the event the taxpayer does not maintain adequate records in subsequent years to substantiate amounts claimed. Although we believe this procedure was the best that could be devised in the current circumstances, we are aware that it will not cure the basic problem created by taxpayers estimating certain of their deductions. Also there are problems inherent in making two different applications of the Cohan rule. As indicated above, the examiner has no standard to guide him and our new procedure aggravates this situation by requiring a "more strict" interpretation of the rule in appropriate instances on subsequent examinations. Uniformity of determination, of course, cannot be promoted in this way.

The Service's problems in this area are not confined to estimated entertainment expenses and cash transactions. As you know, credit cards and hotel charge accounts are used to

purchase a wide variety of items and services. In many instances detailed receipts covering the individual items charged by the taxpayers are not available to examining officers. Great difficulty is therefore often encountered in distinguishing between personal and business expenses when a taxpayer presents as substantiation monthly statements from credit card companies and hotels. A similar problem exists with respect to country club expenses.

Another type of entertaining which creates enforcement problems is that involving business acquaintances who take turns picking up each others luncheon or entertainment checks without regard to whether any business purposes are served. In these situations the person being entertained and the person entertaining often have an apparent business relationship, making detection of the practice very difficult.

In addition to the foregoing problems, the Service is faced with the possibility that taxpayers may take advantage of the provisions of the so-called 6(a) regulations (Section 1.162-17). Under these regulations employees who receive expense account allowances or reimbursements from their employers need not include them on their income tax returns if they account to their employers for such expenses. If all employers maintain adequate methods of requiring an accounting from their employees, the above regulations would not bring about any new problems. However, there are some cases in which employers give their employees expense account allowances which are in reality additional compensation. In a limited study conducted in late 1959 to determine the extent of abuses in this particular area we found that 26 employers of the 174 employers examined did not use acceptable business practices in requiring an accounting of business expense by their employees. In these 26 cases it was found that 153 employees of a total of 339 employees' returns examined resulted in additional taxes as a result of erroneous treatment of amounts received from their employers as expense account allowances or reimbursements.

Another examination problem the Service has in connection with T&E expenses results from the fact that many taxpayers bury their entertainment expenses in several different accounts. This is sometimes done by design in order to obviate the chance of the Service selecting the return for examination. In other cases, especially with respect to large corporations, the entertainment expenses are not identified on the return as such, but are broken down in the functional activities that

generated the expenses, e.g., administrative expenses, production expenses, etc. In one case it was found that $76,000 paid to stockholder-officers for entertainment expense was included in the deduction for metal purchase expense. This practice not only makes the selection of returns for examination more difficult, it makes it impossible for the Service to obtain meaningful statistics regarding the total amount of T&E and similar expenses claimed by taxpayers.

The Service also has difficulties with respect to so-called business gifts. Frequently, taxpayers cannot prove that they made the expenditure at all. Furthermore, many taxpayers who can prove that they purchased gift items cannot or refuse to give examining officers the names of the donees. In some cases this is done to protect the donee from possible imposition of an income tax on the value of the gift. In other cases we believe the purpose is to conceal gifts made to public officials in violation of public policy or to protect employees of vendors or vendees who accepted gifts contrary to the policy of their employers. Furthermore, gifts to friends and relatives are often claimed as business deductions.

The examination problems can best be illustrated by an example of a taxpayer in business who buys $1,000 worth of liquor and claims a deduction for that amount as a business gift. He can support the expenditure by showing a canceled check; however, further supporting evidence concerning the donees of the liquor is seldom available. It may well be that the entire amount is fully deductible; yet, it is difficult for the taxpayer to show the names of the beneficiaries and more difficult for the examining officer to determine whether the deduction claimed constitutes an ordinary and necessary business expense.

We have also had difficulty in enforcing Section 1.162-2(b) of the regulations relating to the primary purpose of travel as distinguished between personal and business. In enforcing this provision the Service has to deal with the intent of the taxpayer as well as all the other difficult fact-finding problems. Some cases are black or white - the personal or business purpose is so clear that no problems are involved. In other cases it is extremely difficult to determine whether the trips were primarily for business or personal purposes. Many times a taxpayer will combine a business trip with a vacation. Perhaps the business trip would not have been made if it were not for his vacation plans. As you know, we encountered this problem in the examination of returns of lawyers attending the recent American Bar Association conference in London and continued on a sightseeing

trip throughout Europe. One of the objective methods used by our field offices in considering such cases is to determine the relative amount of time spent on personal vs. business activities during the trip and to ascribe as the primary purpose the activity to which the taxpayer has devoted the greatest length of time. However, our experience reveals that the "all or nothing" approach of the primary purpose rule impairs our public relations because some taxpayers who receive no deduction for a combined vacation and business trip may be aware that other taxpayers, on slightly differing facts, obtain a complete deduction for travel to the business destination.

Scope of the Problem

The number of returns examined each year in which T&E expenses are involved and the average size of adjustments made in these cases are not known. Without question, information of this type would be valuable. To date, however, our reporting system has not had sufficient capacity to permit incorporation of the data. As you will recall from our discussion of February 14th, in connection with our present study of T&E expenses we asked our field audit examining officers to submit, during the period October 1, 1960 through December 31, 1960, certain statistical information on all examined business returns on which deductions were claimed for travel, entertainment and similar expenses. For the purpose of this study business returns were considered as all returns in the 1120 series, all 1065 returns, and 1040 returns reporting adjusted gross income in excess of $10,000 with Schedule C or F attached or a separate schedule in lieu thereof. The statistics showed that 37,933 returns were examined and in 18,169 cases it was necessary to adjust T&E expenses. In these cases adjusted, the average tax change was $615.

To further illustrate the scope of these problems, at the present time entertainment and travel expenses (which are grouped together for statistical purposes) are the most frequent issues in informal conferences held by the Service on field audit cases. In office audit informal conference cases, these cases rank second to dependency questions.

We believe that there is a small percentage of cases in which the abuse in this area is so flagrant that there is outright fraud. At the present time several of these cases are being considered by our Intelligence people for consideration of criminal prosecution. However, I understand that in this type of case it is difficult to secure convictions because of the heavy burden of proving the taxpayer's intent to defraud the Government.

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The Burden on the Service in Terms of Employment of its Available Manpower

The Service does not maintain records regarding the amount of time expended by examining officers and other technical personnel with respect to specific issues or provisions of law. Therefore, we are not in a position to quote any figures regarding the amount of time and money expended in connection with administering the present provisions of the Code and regulations as they apply to T&E expenses. However, on the basis of the experience of our operating officials and employees a great deal of the Service's resources are spent in this area. We believe that under existing substantive rules on T&E expenses our current expenditure of time is essential in order to insure voluntary compliance by taxpayers and to prevent further abuses.

The Effect of our T&E Policy on Taxpayer Relations

One of the most difficult problems our examining agents face during the course of their audit of returns is to maintain good taxpayer relations during the course of verifying T&E expenses. There is no problem involved in those cases where the taxpayer has complete records and supporting data to substantiate his claimed deductions. However, where the examining officer finds it necessary to ask the taxpayer questions regarding the nature of the claimed deductions, the taxpayer very frequently adopts a defensive attitude. This attitude is natural since the examining officer may be considered to be questioning his veracity. This problem is compounded when it is necessary to reconstruct the taxpayer's deduction under the Cohan rule. It is likely that the examining officer cannot accept all of the unsupported oral testimony offered by the taxpayer. In that case, the taxpayer will feel that the Service does not accept his statements as being truthful.

On the other hand, if the taxpayer has overstated his T&E expenses and upon examination he is not questioned regarding them or the examination is not sufficiently thorough we believe it is likely for the taxpayer to increase his overstatements of these expenses in the future.

Sometimes the Service receives complaints that there is a lack of uniform treatment of taxpayers in allowing claimed expenses for T&E. In many of those cases, however, the facts are either not clear or are unavailable to the examining officer. It is impossible to make uniform decisions as to whether a particular expenditure is an ordinary and necessary business expense when there is no concrete information regarding the nature of the expenditure or the business purpose thereof. It is necessary for each examining officer to weigh all the available evidence and to determine the weight to be given to the oral testimony given by the taxpayer. This is primarily a judgment area where reasonable and competent examining officers can differ in the treatment given in the same case.

With respect to travel expense we find that it is easier to give uniform treatment to taxpayers than with respect to entertainment expenses. However, we have had difficulties even in this area when a uniform rate of automobile expense deductions has been used in certain localities.

The costs of operating an automobile not only vary between areas but between different taxpayers within the same area. If a taxpayer drives 30,000 miles a year his costs are less per mile than for a taxpayer that drives the same kind of auto only 10,000 miles a year. Also it costs less to drive a Volkswagen than it does to drive a Cadillac. For these reasons, except where we are required by regulations to accept uniform figures, for example, we prefer to use the actual costs or, if these costs are not available, to reconstruct his deduction based on the facts of the particular case. Perhaps the most important feature in our relations with taxpayers concerns those who have no opportunity to claim T&E or other business expenses. Many newspapers and magazines have published articles which have caused a large number of taxpayers to become incensed at the apparent inequities in the administration of the tax laws. There is evidence in our recent T&E study that these articles may have motivated some taxpayers to claim T&E expenses which they did not actually incur. While we do not feel that this situation is widespread at this time, any breakdown in voluntary compliance is viewed with extreme concern since the very foundation of our tax system is built on this principle.

Burden on the Taxpayers in Complying with the Service's T&E Program

The Service recognizes that some expenditures for T&E expenses such as those involving nominal amounts for tips and taxi fares

are difficult to support. Because of this the Service has been compelled to adopt a policy of reasonableness in requiring supporting records for this type of expense. In support of T&E deductions, Revenue Ruling 60-120 requires taxpayers to maintain records reflecting the following information:

(a) The relationship of the expenditure to the taxpayer's business;

(b) The payee and place of the expenditure;

(c) The amount of the expenditure;

(d) The nature of the product or service received;

(e) The identity of the person or persons entertained, or the recipient of any gift (by name or title or otherwise); and

(f) Evidence of payment where the amount of the expenditure is large, or the nature of the expenditure is unusual.

Basically Revenue Ruling 60-120 contains nothing new with respect to recordkeeping requirements since the Service has always required this information. However, we have found from experience that many taxpayers fail to keep records to support their T&E expenses even though they maintain excellent records with respect to all other business expenses. Moreover, when we request these taxpayers to support their claimed T&E deductions they feel that the Service is imposing a burden upon them. On the basis of our prior experience, we do not anticipate any appreciable improvement in recordkeeping by taxpayers in this area as long as the Cohan rule continues to be an integral part of the law.

Conclusion

From the standpoint of the tax administrator there are certain difficulties which have proven to be insurmountable barriers to the achievement of our goal of effective and equitable enforcement of the provisions of the present law relating to T&E expenses.

The Service's enforcement program announced in TIR No. 221, together with the newly established examination procedures, is the most effective administrative step feasible under the Code. This measure, however, will be ineffective to eliminate the basic administrative problems inherent in the present law.

In view of the personal nature of T&E expenses, it is impossible to accurately delineate between business and non-business expenses. Each decision must necessarily be arbitrary to some extent. Although tax administrators have been faced with this problem for more than 40 years, no solution has been advanced to resolve it on an equitable and sound basis.

The failure of large numbers of taxpayers to maintain adequate records to support their T&E expenses coupled with the wide and generous application of the Cohan rule results in controversies which can never be resolved with assurance that the taxpayer has paid the correct amount of tax. As we have indicated previously, this aspect renders our task of making uniform determinations more difficult. Furthermore, we fear that this is an area where there is a likelihood that our examining officers may make overallowances of T&E deductions in order to close cases on an agreed basis.

Another problem in effectively and equitably carrying out our responsibilities in this area is the fact that we can now examine only little more than 4% of all returns filed. Although by our classification procedures we attempt to identify those returns on which T&E expenses appear to be overstated, our total enforcement effort in this area does not provide sufficient examination activity to insure a high degree of voluntary compliance. However, even if the enforcement staff was increased to permit the examination of all returns on which T&E expenses are claimed, the problems caused by the personal nature of T&E expenses and by the failure on the part of taxpayers to keep supporting records will not be resolved.

Commissioner

EXPENSES FOR TRAVEL, ENTERTAINMENT, AND BUSINESS GIFTS

- PART THREE -

Analysis of
Some Court Decisions and Administrative Cases
Allowing
Deductions of Entertainment and Related Expenses

INTRODUCTION

Collected here are summaries of judicial decisions and administrative cases which illustrate the type of expenditures for entertainment and related items which are allowed as business deductions under present law.

Recently the National Office of the Internal Revenue Service requested district offices to submit cases involving expenditures for parties, business gifts, yachts, hunting lodges and similar items which would illustrate how a relatively slight business element is sufficient to require a revenue agent to allow the deduction of an essentially personal type of expenditure under present law. The cases collected here are typical of expenditures for entertainment which are claimed and allowed in a large number of cases.

These cases show that stricter enforcement procedures cannot solve the problem. Stricter enforcement can only require more detailed documentation of amounts expended and the purpose of the expenditure. But, as these exhibits show, this documentation already exists in a large number of these cases. And where the documentation exists, the present law requires that the entertainment expenses be fully allowed. When existing law allows the cost of a safari to Africa, undertaken by a hunting enthusiast and his wife, to be deducted on the ground that it provides advertising for dairy milk, one cannot expect revenue agents to successfully question the business necessity for duck hunting or night-clubbing with business associates.

Excerpts from the reports of two revenue agents, submitted in connection with this study, highlight the situation under existing law. One revenue agent reports that:

> "The President and one Vice-President [of the taxpayer corporation] are father and son. * * *. The father and son own memberships in the ---- Club, ---- Country Club, and various supper clubs. * * * The corporation pays all dues and entertainment expenses * * *. It is, however, believed that the entertainment involves friends, and that the officers are in turn entertained by the same people whom they entertain when they pay the bill. * * * Each member of the club is supposed to give a party once each year for the others.
>
> "It has proven impossible to prove such entertainment and parties as personal expense because the officers can always point to some of the parties who were supposedly instrumental in their having obtained some [business] * * *.
>
> "One thing is ever present with this taxpayer. A trip to Las Vegas, Nevada; Havana, Cuba; or some other place has always been opportune to attend some New Year's Day bowl game or other affair, yet the trip was to see some concern about selling * * *."

Another revenue agent states:

> "The president of the corporation is a gun collector and hunting enthusiast. Each year he goes on a hunting trip to Wyoming in the company plane or car [with four hunting companions] * * *.
>
> "The four hunting companions were from * * * firms who may be instrumental in the award of contracts * * * and are hunting enthusiasts themselves as well as friends of the president * * *.
>
> "It has further come to the attention of the examiner that officers' salaries are held to a minimum * * *, but the expenses of the above nature are paid in behalf of the officer. It should be added that all events of the trip and associations of the companions are carefully documented and reported to the firm to avoid possible trouble in connection with the deduction.
>
> "Under present law there has been found no basis for disallowance of the expense."

Administrative cases number 1 through number 41 were submitted as Part Three of the entertainment expense study presented to the House Ways and Means Committee last year. Cases number 42 through 60 further illustrate the basic expense account problem. These cases are samples from subsequent audits. In cases number 42 through number 54 substantially the entire amount claimed as a deduction was allowed. Cases number 55 through number 60 are examples of a great number of cases where a substantial portion of the deduction claimed is disallowed because the expenses are purely personal with no business connection but the remainder is allowed because a slight business connection is shown. Of course, to the extent that cases of this kind are not examined by a revenue agent the entire amount claimed, including the purely personal part, is effectively deducted.

ANALYSIS OF COURT CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED BY TAXPAYER	AMOUNT ALLOWED BY COMMISSIONER	AMOUNT ALLOWED BY COURT	SUMMARY OF FACTS
1	Dairy	Safari to Africa	$ 16,818	$ 1,200	$ 16,443	In 1950, the taxpayer, a closely held corporation engaged in the business of processing and distributing milk and milk products, paid the expenses for an African hunting safari for its principal shareholder-president and his wife. The president was an experienced hunter. The trip, which included stays at London, Paris and Rome, lasted approximately six months. Taxpayer received publicity as the sponsor of the trip, both in the newspapers and by the exhibition of motion pictures and hunting trophies. The Tax Court concluded that the taxpayer's primary intent was to publicize the business and was not to benefit the officer and his wife. The Court allowed the deduction of expenses in full by the taxpayer. Sanitary Farms Dairy, Inc., 25 T.C. 463 (1955).
2	Brewing company	Cabin cruiser	$ 10,481	$ 6,785	$ 10,481	Cabin cruiser expense incurred during the years 1949 and 1950. President of company testified that the cruiser was used solely to hold sales meetings and to entertain customers and distributors; that it was especially necessary to own a cruiser because company' plant was located in a slum area where it was not feasible to conduct sales meetings or to meet with customers and distributors; that there was a constant need to generate goodwill. "Customarily on weekends they took a group of distributors or take out people or large dealers fishing down to the islands if the weather permitted." The Tax Court allowed the deduction in full. Cleveland-Sandusky Brewing Corp., 30 T.C. 539 (1958).

ANALYSIS OF COURT CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED BY TAXPAYER	AMOUNT ALLOWED BY COMMISSIONER	AMOUNT ALLOWED BY COURT	SUMMARY OF FACTS
3	Diversified manufacturing	Redecorating principal officer's residence	$10,000	none	Jury verdict in favor of taxpayer for 95 percent of refunds claimed.	Taxpayer corporation reimbursed its principal shareholder-officer for a portion of the cost of refurbishing the first floor of his residence. Taxpayer deducted this reimbursement, contending that this residence was used for entertaining its customers and thus served its business purposes. The jury was instructed that there was nothing wrong with the use of a private residence for a business purpose if it was ordinary and necessary. The Court said that the question for the jury was whether a business advantage was expected and whether it was realized.
		Swimming pool adjacent to residence	$ 6,600	$ 1,650		Taxpayer also claimed depreciation on a swimming pool constructed on land which it owned. The pool was adjacent to the shareholder-officer's residence and could be entered only from that residence. The jury was instructed to find for the taxpayer if it was satisfied that, as taxpayer contended, the pool was purchased for business use and in anticipation of benefits to the business. Doughboy Industries, Inc. v. United States, 4 AFTR 2d 5021 (W.D. Wis. 1959).

ANALYSIS OF COURT CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED BY TAXPAYER	AMOUNT ALLOWED BY COMMISSIONER	AMOUNT ALLOWED BY COURT	SUMMARY OF FACTS
4	Manufacturer of witch hazel	Yacht	$10,949	none	$ 9,789	The taxpayer, an individual engaged in manufacturing witch hazel, purchased a yacht for the entertainment of customers and potential customers. The yacht was used to encourage such persons to visit taxpayer's plant. Although the Commissioner disallowed the expenses as personal, they were for the most part allowed by the Board of Tax Appeals because of the business relationship which the taxpayer had established. E.E. Dickinson, 8 B.T.A. 722 (1927)
	Horse racing secretary and handicapper	Yacht and entertainment	$2,000	none	$2,000	Taxpayer, an individual engaged in the occupation of scheduling and making other arrangements for horse races and handicapping horses, entertained racing officials, track owners, horsemen and turf writers by arranging dinners and theater parties and providing recreation aboard his yacht. The Court found that taxpayer's business was highly competitive. The expenses for entertainment claimed as a deduction by taxpayer were held to be expended for the purpose of promoting taxpayer's business. Taxpayer's effort to maintain friendly relations with those entertained was viewed as essential to his continued success. The deductions claimed were allowed in full. Charles J. McLennan, T.C. Memo. Op. Docket No. 4757 (June 25, 1945), ¶ 45, 217 P-H T.C. Memo.

ANALYSIS OF COURT CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED BY TAXPAYER	AMOUNT ALLOWED BY COMMISSIONER	AMOUNT ALLOWED BY COURT	SUMMARY OF FACTS
6	Manufacturing paints and related products	Cabin cruiser	$ 28,039	$ 2,000	$ 21,029	Taxpayers were general partners engaged in the business of manufacturing, buying and selling paints and related products. They claimed a deduction for fiscal years 1952 and 1953 for the operating expenses and depreciation of a boat. The boat was principally used for entertaining financiers, suppliers, and other persons with whom the partnership had business dealings. It was also used for testing work in connection with marine paints and for the personal pleasure of the taxpayers and their families. The Court allowed 75% of the boat expense as a business deduction. Greenberg v. Riddell, 4 AFTR 2d 5040 (S.D. Cal. 1959
7	Automobile dealer	Cabin cruiser	$ 992	0	$ 310	Taxpayer was one of two partners in a partnership selling used cars at retail. The partnership maintained a cabin cruiser which was used partly for business purposes and partly for personal recreation. The Tax Court stated: "An expense of this nature, where reasonably related to the operation of the business, may be deducted as an ordinary and necessary expense. ...Except for generalities, the criteria upon which the petitioner's basis for determining whether they were business or personal expenses were not disclosed in his testimony". Nevertheless, with respect to taxable year 1949, the Court allowed about one-third of the claimed expense. Charles M. Kilborn, 29 T.C. 102 (1957)

ANALYSIS OF COURT CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED BY TAXPAYER	AMOUNT ALLOWED BY COMMISSIONER	AMOUNT ALLOWED BY COURT	SUMMARY OF FACTS
8	Solicits and writes insurance	Vacation camp	$1,833	none	$1,629	Taxpayer, an individual engaged in the general insurance business, owned a vacation cottage which was used partly for family vacation and partly to entertain customers and prospective customers. Taxpayer frequently held stag parties for businessmen on weekends. Recreation took the form of boating, eating, drinking and playing poker. The cottage was on a lake and boating facilities were maintained by the taxpayer. The property was sold in 1944 at a loss. Taxpayer claimed a deduction for 75 percent of the loss and 75 percent of the depreciation for that year. The Tax Court found that the property was used two-thirds of the time in taxpayer's business and allowed two-thirds of the loss and depreciation as a business expense deduction. Walter O. Kraft, T.C. Memo, Op. Docket No. 14975 (June 22, 1949), ¶ 49, 159 P-H TC Memo.
9	Actor	Entertainment	$1,687	none	$1,687	Taxpayer, a professional actor, incurred expenses for theater tickets, luncheons, suppers and other entertainment which he provided to a variety of individuals for purposes of publicity and public relations and to enable him to secure theatrical engagements more easily. The Board of Tax Appeals sustained the Commissioner's disallowance but was reversed on appeal. The Circuit Court noted that this entertainment tended to promote the taxpayer's popularity and thereby to increase his income from acting; the expenses were therefore held to be ordinary and necessary. The Court said "As the word 'necessary' is used here, we think it means 'appropriate' and 'helpful.' " Blackmer v. Commissioner, 70 F. 2d 255 (2d Cir. 1934)

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
1	Manufacturer	Hunting lodge	$61,146 71,206 55,065	$61,146 71,206 55,065	1956 1957 1958	Closely held corporate taxpayer maintains a luxurious hunting lodge which had a 1958 tax basis of over $230,000 and is constantly maintained by caretaker and wife. Streams stocked with trout, small game raised by farmers for purpose of stocking, and large deer population. Log maintained showing names and dates representatives of customers are entertained. Lodge also used for entertainment of key personnel of taxpayer. Log indicates use by 500-600 persons annually.
2	Manufacturer	Maintenance of resort facilities on sub-tropical island	$353,713	$269,666	9-30-57	Taxpayer, a domestic manufacturing corporation, owns luxurious facilities on a sub-tropical island. The principal use of the property is for entertainment of executives and key personnel of customer firms. Fishing cruisers are maintained and air transportation furnished guests. The Chairman of the Board, who is the controlling stockholder, and other officers and key employees accompanied by their families spent considerable time at island. Adjustment was made for amounts considered personal expenses of these officers and employees.
		Airplane expense	90,666	90,666		
		Airplane depreciation	20,439	15,277		

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
3	Supplier	Yacht		$111,804	1953-54	Taxpayer's stock is owned by two individuals. Yacht was used by company for fishing parties for customers and company personnel. Yacht expenses shown are only for 1953 and 1954; it is estimated that operating expenses, exclusive of depreciation, are $75,000 per year. Ranch properties are leased by taxpayer from stockholder and from others and are used by customers for hunting and fishing. Night club expense was paid by company to a club owned by stockholder to cover charges made by company executives and sales personnel ($23,000 of this amount was charged at club by stockholder). Parties are held at club during Christmas season and cost of each party ranges from $8,000 to $14,000. Each year the company finances a hunting trip to Canada for executive personnel and customers and minimum cost is $5,000 to $6,000 for a party of 8 to 12 men. Corporate expenditures which were not allowed as a deduction included over $20,000 paid for additions to personal residence of stockholder and over $9,000 for vacation trips to Europe and Africa by stockholder and family. Item of "other entertainment" represents reimbursement for travel and entertainment by stockholder.
		Ranch-hunting lodges		116,440	1953-59	
		Night club expenses		126,249	1954-59	
		Other entertainment		119,647	1953-59	

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
4	Insurance	Meals	$25,000		1957	Individual taxpayer travels widely while visiting insurance agency offices. At each office the taxpayer entertains office personnel lavishly for the apparent purpose of establishing good management-employee relations. Taxpayer also lavishly entertains management personnel at Florida vacation resorts. The disallowance of $40,000 of expense was based on either lack of substantiation or claim stated in wrong year; it was not based on failure to establish a business relationship for the expense.
		Lodging	20,000			
		Transportation	30,000			
		Food and beverage for entertainment	30,000			
		Tickets	2,000			
		Conventions	1,000			
		Apartment	6,000			
		Gifts	10,500			
		Other	3,000			
		Auto	10,000			
			$137,500	$97,500		
5	Food Products	Hunting trip	$ 12,211	$12,211	1951	The trip was given considerable coverage by the newspapers. Films of the trip were exploited successfully in connection with taxpayer's business. The deduction was allowed based on decision of the Tax Court on a similar issue.
			14,325	14,325	1952	

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SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
6	Supplier	Gifts	$10,521 9,304 5,941	$10,521 9,304 5,941	1953 1954 1955	President of closely held corporate taxpayer traveled extensively with officers of a customer to various plants, conventions, and on the "horse show circuit". On these occasions he entertained officials of customer at cocktail parties, dinners, etc. Taxpayer contended that it was essential to maintain close personal relations with officers and employees of its customer. It was taxpayer's policy to give gifts to key employees of customer. Entertainment expense of $44,230 for 1954 is typical and was expended as follows: Local hotels and clubs — $7,500 Out-of-town hotels & clubs — 14,000 Cash to officers, entertainment — 8,700 Transportation — 1,000 Food, liquor, cigars for office and farm — 5,400 Florida hotel expense — 7,500 Most of the expenditures were made by the president of taxpayer.
		Entertainment	51,259 44,230 23,898	38,444 33,172 17,924	1953 1954 1955	
7	Sales of steel equipment	Farm resort	$20,000	$20,000	1958	Corporate taxpayer expended $20,000 to maintain a large plantation and farm type residence in a resort area for entertainment of top echelon executives of various large customers of the taxpayer. The expenditure of $5,000 was for a golf party for executives of various customers of the taxpayer. This same situation existed in prior years and was accepted.
		golf party	5,000	5,000	1958	

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
8	Mortuary business	Yacht	$ 11,455 11,096 12,776	$ 8,591 8,322 9,582	1955 1956 1957	Yacht owned by this closely held corporation was used to entertain visiting morticians, clergymen, and for meetings of employees. Taxpayer prepares and ships bodies to other areas for burial. Personal residence of principal shareholder has an office and residence is used for business meetings and entertainment of business guests.
		Cottage expense and entertainment	4,424	2,875	1955	
		Personal residence and entertainment	12,271 14,686 10,762	7,362 8,811 6,457	1955 1956 1957	
9	Ship repair	Christmas party	$ 23,758	$ 23,758	1956	Taxpayer is a closely held family corporation. During the Christmas season of 1956 the corporation gave a dinner at a large hotel, which was attended by customers of the firm and business acquaintances of the corporate executives. The cost of the affair was allowed as deduction on the ground that the purpose for the expenditure was to create goodwill and to enhance the repute of the corporation.
10	Beverage manufacturer	Kentucky Derby	$ 10,903	$ 10,903	4-30-58	Customers and their wives are entertained by Derby parties such as breakfasts and luncheons, etc.; by furnishing box seats and tickets for the Derby; and entertainment at the Derby.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT		TAX YEAR OR PERIOD	SUMMARY OF FACTS
			CLAIMED	ALLOWED		
11	Textile manufacture	Plantation resort	$ 34,258 31,950 29,022 32,924	$ 22,839 21,300 14,511 16,462	9-3-55 9-1-56 8-31-57 8-30-58	The corporation leased a plantation from a stockholder of the corporation for an annual rental of $1.00. The stated purpose of the lease was to provide the corporation with a place to entertain customers and business associates. Although it appeared that some business purpose was served by the rental of the plantation it was determined a portion of the expenditures to be personal to the stockholder. The disallowed portions of the deductions were taxed to the stockholder.
12	Food products	Guest House in Resort area	$ 13,500 14,300	$ 13,500 14,300	2-28-59 2-28-60	Taxpayer corporation is located on west coast and most of its sales are made through brokers from the eastern U.S. and Europe. While they are out on the west coast, the brokers expect the sellers to provide them a place to stay and taxpayer established that the purchase of the guest houses was for this purpose. The taxpayer also established that the facilities were used by its sales representatives for making sales.
13	Coal & Iron Mining	Cottage in Canada	$ 11,983 10,509	$ 11,983 10,504	1959 1960	Cottage on bay in Canada was used to entertain people connected with ingot steel industry. Eighty-seven persons were entertained in 1960.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
14	Steel Products	Residence Miami Beach	$ 33,206	$ 28,706	4-30-56	The taxpayer, which is located in the midwest, asserted that lavish entertainment is essential in obtaining business and it established a Miami residence for this purpose. The two principal officers and their wives are usually present at the residence when entertaining customers. Deductions allowed include depreciation on residence, food, liquor, boat expense and salaries of service employees and entertainment. Disallowance was made for amounts deemed to be personal expense.
15	Hosiery Mill	Beach House and Boat	$ 25,367 32,713	$ 25,367 32,713	1957 1958	Expense of beach house and boat maintained by corporate taxpayer to entertain business guests was allowed in full.
16	Mineral Products	Summer home & residence	$ 40,256 42,858 36,696	$ 20,128 21,429 18,348	1956 1957 1958	Closely held corporate taxpayer located in midwest maintains a summer home in Maine and a residence in midwestern city. Principal stockholder and wife spend 2-1/2 months each summer at the Maine home and entertain high officials (and wives) of customers. The property in midwest is used to entertain visiting buyers and is used occasionally by president of company and his wife.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
17	Road Building Equipment	Club expense	$ 6,700	$ 6,700	1959 & 1960	These expenses are incurred primarily by the top three officers of the company. In general, the club expenses are for lunches, dinners, parties, and convention expense on behalf of customers. The liquor is purchased for the bar in the office and is kept for customers who drop in. Expense for conventions are for various groups who have their conventions in the taxpayer's home city; however, a good share is for conventions that the officers attend in resort cities.
		Liquor	13,750	13,750	"	
		Season Football Tickets	2,004	2,004	"	
		Convention Expenses	4,250	4,250	"	
		Convention	$ 1,400	$ 1,400	1959	Expenses for tractor demonstration attended by corporate taxpayer's principal officer-shareholder and his wife. A purported business reason for the wife's travel was established based on allowance of expenses for similar travel in the past.
		Travel to Construction Job of one of Taxpayer's Customers	$ 2,600	$ 2,600	1960	Such shareholder and his wife traveled to Alaska with customer and wife. Expense of wife was allowed based on representation that customer would not go without his wife and his wife would not go without such shareholder's wife.

(continued on next sheet)

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
17 (continued)		Speedboat	$ 1,410	$ 1,410	1959-1960	Speedboat was used exclusively at officer-shareholder's personal cottage, yet a log was kept which showed that the boat was used solely for the pleasure and convenience of customers of the taxpayer corporation.
		Party	$ 675	$ 675	1960	Christmas party given by such officer-shareholder cost $850. It was claimed that most of guests were business customers or potential customers. Accordingly $675 of the $850 was claimed and allowed as a business expense of taxpayer.
		Las Vegas Vacation	$ 1,500	$ 1,500	1960	Officer-shareholder and wife accompanied customer and wife to Las Vegas for 12 day vacation. Taxpayer paid the expenses for the four individuals. Officer-shareholder asserted that he would not have made the trip except for business purposes and that his wife's presence was required by the customer and his wife.
18	Manufacturer of equipment	Lease of hunting lodge	Approx. $75,000	Approx. $75,000	1956 1957 1958	Taxpayer leases a hunting lodge and duck hunting preserve for a minimum rental of $1,800 per month. It is engaged in manufacture of equipment and has its products distributed by several firms located throughout the U.S. Customers of each firm are entertained at the hunting preserve. A log is maintained and it disclosed no personal use by stockholders. Taxpayer shares expenses of lodge with two other taxpayers. The total expenditure claimed for this lodge by the three taxpayers for the years 1953-1959 is $666,000 and it appears that most of this expense was allowed.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
19	Manufacturer	Yacht	$272,640	$253,035	2-28-54 2-28-55 2-28-56	Taxpayer, in addition to other large entertainment expenses, maintained a yacht primarily for the purpose of entertaining dealers who sell taxpayer's products. The disallowed portion of the expenses was for the estimated personal use by taxpayer's officers.
20	Automobile Dealer	Yacht	$ 290 6,204 7,401 10,761	$ -0- -0- 7,401 10,761	1946 1947 1948 1949	Corporation purchased yacht for purpose of providing free rides to customers upon purchase of an automobile. Log maintained indicated passengers were customers. No boat trips were made unless the principal stockholder was aboard. This case was settled by stipulation while in a docketed state in Tax Court.
21.	Cake and Cookie Bakery	Yacht	$ 18,000 22,000 26,000	$18,000 22,000 26,000	1957 1958 1959	Taxpayer sells cakes and cookies to grocery stores. The yacht was used exclusively to entertain super market and chain store buyers and branch managers on deep sea fishing trips for promotion purposes.
22	Shoe manufacturer	Yacht	$ 20,907	$16,943	Not available	Purpose of expenditure was stated to be the use of the boat to demonstrate to customers a non-skid sole sneaker made by taxpayer. Used at various Atlantic and Gulf coast ports.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
23	Automobile Dealer	Yacht expense	Not Available	$ 22,692	1956	The taxpayer maintained a guest list record which disclosed that the yacht was used for entertainment of old customers, officials of an automobile manufacturer, automobile dealers and prospective customers.
24	Oil and Refining Corp.	Hunting trip	$ 1,240	$ 1,240	1958	Elk hunting trip for party of six. Fishing trip to Canada for party of eleven. These trip expenses were incurred to entertain officers and managers of various oil and pipeline companies from which taxpayer acquired its crude oil.
		Fishing trip	3,855	3,855	1959	
25	Auto Dealer	Airplane	$20,000	$ 20,000	1958	Used for entertainment, travel, advertising. Records support claimed deduction for depreciation and maintenance of airplane used in entertaining customers and prospective customers.
26	Metals manufacturer	Yacht expense	$ 7,999	$ 5,500	1957	Boat was acquired in order to create a more intimate relationship between this corporation, through its officers, and its sources of supply. The amount allowed represented the portion spent which related to business purposes.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
27	Sale of fuel	Hotels, restaurants, boat club, parties, gifts, etc.	$60,000	$40,000	1958	The amounts claimed included expense-paid vacations for officials and employees of customers at resort cities in Florida. The taxpayer contended that such entertainment served to maintain and increase its sales volume.
28	Sale of fuel	Yacht	$34,189 24,063 34,787	$34,189 24,063 34,787	9-30-57 9-30-58 9-30-59	The yacht, which was acquired by the corporate taxpayer in 1954 at a cost of $80,314, is used for sales promotion purposes. Customers and prospective customers are frequently entertained on it. When used for nonbusiness purposes, either by taxpayer's officers or by other persons, a rental charge of $250 per day is made, which is credited to the yacht expense account.
29	Food products	Yacht and resort residence	$26,031	$23,491	10-31-58	Corporate taxpayer is owned by two individuals, is located in a midwestern State and maintains a residence in Miami, Florida. The taxpayer established that the Florida residence is maintained for the use of personnel of customers and prospective customers and must be staffed and available for use all through the year. The taxpayer contended that the Florida residence and yacht were used to great advantage with suppliers, who expedited delivery schedules, and were helpful also in persuading larger packers to place orders. A sufficient business element was considered to be present and the deduction was allowed under present law.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
30	Consultant to manufacturer	Duck Hunting Club	$ 4,211	$ 4,211	1957	Individual taxpayer served as consultant to manufacturing company with annual compensation of $25,000. Expense was incurred for entertaining customers of company at a duck hunting club owned by taxpayer.
31	Lawyer	Yacht	$ 6,475	$ 6,475	1958	The taxpayer is engaged in the litigation of claims as a specialist. In 1950 he acquired a cabin cruiser. The cost of the maintenance and operation of this boat in 1958 amounted to $6,975. Of this amount the taxpayer claimed and was allowed $6,475 as an ordinary and necessary business expense on a showing that the boat was used primarily for entertaining clients and business executives for the purpose of establishing professional contacts.
32	Exclusive Sales Representative	Entertainment	$55,000	$53,645	1959	Corporate taxpayer, a manufacturer's sales representative, leased the yacht in 1959 for $1,000 per month from a partnership consisting of two individuals who are officers of taxpayer. Partnership was formed in 1959 and acquired yacht in April of that year. Corporation rents the yacht back to the partnership for two months each year at a monthly rental of $1,250. Yacht expense and entertainment expense are incurred to maintain goodwill with customers of the taxpayer.
		Yacht	13,710	3,710	1959	

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
33	Processing cloth	Residence	$21,183	$ 8,472	1955, 1956 and 1957	It was determined that 40 percent of the amount paid by the corporate taxpayer to its president-shareholder was to reimburse him for entertaining business guests of the corporate taxpayer and thus was allowable. No guest register was maintained but taxpayer was able to establish that customers were entertained at the president's residence. Disallowances were based in part on lack of substantiation and in part on failure to relate some expenses to a business purpose. The expense of a hotel suite maintained by the taxpayer was allocated between business and nonbusiness use. Gifts and football tickets for taxpayer's customers were allowed in full.
		Entertainment	32,051	23,101		
		Hotel suite	7,200	3,600	"	
		Gifts	3,300	3,300	"	
		Football tickets	1,246	1,246	"	
34	Wholesaler	Promotion	$ 49,329	Under examination	1957, 1958 and 1959	Taxpayer corporation is a wholesale supplier primarily serving utilities, contractors, and local governments. The expenses claimed are for the alleged purpose of increasing taxpayer's sales. Those expenses which are related to business or potential business with local governments will be disallowed as contrary to public policy
		Football tickets	31,963		"	
		Food and beverages	124,600		"	

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
35	Buying and selling of corporations	Resort residence and luxury apartment	$21,399 16,478	$ 8,559 6,591	1956 1957	The corporate taxpayer's business is that of buying and selling corporations. The taxpayer seeks bargain purchases of controlling stock in other corporations. The taxpayer claims the purpose of maintaining the resort residence is to have a place available for business conferences. The resort residence has facilities for boating, fishing and entertainment. The agent concluded that the personal convenience, pleasure and health of the Chairman of the Board of the taxpayer is the principal reason for maintaining the residence and the apartment. However, the evidence did indicate that there was some entertainment expense incurred for business purposes and a portion of the expense was therefore allowed.
36	Manufacturer	Yacht expenses	$ 13,795 32,527 34,404	$ 13,795 32,527 34,404	4-30-55 4-30-56 4-30-57	Corporate taxpayer, located in northeastern State acquired the yacht in 1954 and used it during the summer predominantly for the recreation of employees. During the winter it is moved to Florida and is used to entertain various business associates, distributors, suppliers, etc., visiting there on vacation.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
37	Selling and servicing new and used cars	Yacht	$ 8,337 17,641 15,282 10,474	$ 5,796 12,530 10,270 6,946	1955 1956 1957 1958	Corporate taxpayer claimed 100% of the depreciation and expenses incurred in operating a yacht. Log records maintained were not complete. Many affidavits were submitted by customers which stated that they were guests on the boat and that they received a "sales pitch" while aboard. The taxpayer's president took the boat to Florida each year for a personal vacation which lasted about 3 months. On several of these trips the president was accompanied by a business associate and many vacationing business associates were entertained. Expenses were allowed for portion deemed attributable to business.
38	Ship building	Yachts	$292,627 354,258 285,617 201,450	$211,204 293,330 247,671 176,046	1955 1956 1957 1958	Corporation owns several yachts. One of the yachts was primarily experimental. The others were used primarily for entertaining customers and prospective customers.
39	Oil and gas	Lodge and boat expense	$ 23,219	$ 19,737	1956-1959	The individual taxpayers are located in a midwestern city. The lodge and boats were used to entertain investors from New York whom taxpayers sought to interest in development of oil and gas properties. Taxpayers also entertained local representatives of oil companies and drillers to encourage their participation in development of oil and gas properties.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
40	Construction of roads	Pleasure resort	$ 77,697	$ 53,000	1959 and 1960	The taxpayer corporation is engaged in heavy construction and sale of construction supplies. Its customers are federal, state, and local governments, other contractors, and the general public. The taxpayer acquired a resort estate which is maintained and serviced at a cost approximating $40,000 per year. The estate has facilities for hunting, boating, and fishing. The purpose of maintaining the estate is to create good will among the various people with whom the taxpayer has business dealings and is specifically used when it is attempting to negotiate or secure a contract. The disallowance of a portion of the expense covers preferential dividends and expenses which are contrary to public policy.
41	Transformer Manufacturer	Entertainment at private club house	$127,067	$127,067	9-30-59	These deductions consist of depreciation, wages and other expenditures made in connection with the taxpayer corporation's private club house which is used for the entertainment of customers and prospective customers.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
42	Automobile Dealer	Boat	$5,681 $6,421	$4,545 $5,136	1957 1958	Taxpayer owned a boat which was used principally to entertain customers. Taxpayer's records established that most of the persons entertained on the boat subsequently purchased automobiles from the taxpayer. Also, it was established that taxpayer's president regularly lived on the boat. A portion of the claimed expenses was disallowed as personal and taxed as income to the president.
43	Manufacturers' Representative	Yacht	$1,956	$1,956	1956	Taxpayer's yacht log showed that a majority of the dozen trips out of port was to participate in races. Most of the business entertainment was conducted while the boat was in port. The amount claimed and allowed was 50% of the operating expense and depreciation.

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SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
44	Manufacturer	Boat	$3,257 $3,985 $2,154	$3,257 $3,985 $2,154	1958 1959 1960	The boat was purchased in 1958 and sold in 1960. It was used to entertain customers and prospective customers, nine times in 1958, thirteen times in 1959, and six times in 1960. Deductions included expenses for gas, oil and entertainment, and depreciation.
45	General Contractor	Yacht	$2,212	$2,212	1959	Taxpayer's yacht was used to entertain customers on fishing trips. Taxpayer maintained a log of the trips made and the persons on board.
46	Banker	Country Club Entertainment	$3,000	$3,000	1960	Taxpayer held a debut for his daughter. Approximately one-fourth of the guests had business connections with the taxpayer. Deduction claimed and allowed was approximately 25% of the cost of the debut.
47	Manufacturers of Automobile Accessories	Yachts, Club dues and related expenses, ship board conventions, hunting and fishing trips, parties.	$993,565	$991.665	1959	Taxpayer corporation did not maintain a separate travel and entertainment account. Additional yacht expenses and airplane expenses were also spread among various accounts. The only expense disallowed was the purchase price of one share of stock in a country club. All other expenses were allowed because taxpayer maintained detailed records, fully documenting all expenses.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
48	Physician	Travel to Europe	$ 1,182	$ 1,182	1960	Taxpayer spent 6 of 22 days in Europe attending a medical congress at which he delivered a paper and presided at one of the meetings. Taxpayer was accompanied by his wife and two children. The expenses attributable to taxpayer were allowed as a deduction because he was improving his specialized professional skills.
49	Territorial Sales Manager for Insurance Company	Entertainment; football games; fishing expeditions; theaters	$ 2,802 $ 1,967	$ 2,802 $ 1,967	1959 1960	Taxpayer sells insurance for several companies. He entertains present and past customers, as well as prospective customers, contending that it is not feasible to stop entertaining once a person has been sold a policy. Taxpayer entertained about twenty-five times in 1960 but fewer than thirty different individuals were entertained.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
50	Whiskey Distillers	Yacht	$49,641	$43,325	1959	Taxpayer corporation purchased and outfitted a yacht. A log and guest register were maintained to show the extent to which the yacht was used to entertain customers and others having some connection with the taxpayer's business
		Tickets	$ 600	$ 600		
		Club dues	$ 975	$ 975		
		Conventions	$15,000	$15,000		
		Gifts	$ 7,280	$ 5,284		
		Other-petty "cash"	$14,323	$ 7,000		
51	Sales of Medical Equipment	Yacht	$ 3,949	$ 3,949	1960	Taxpayer corporation was allowed its entire operating expenses for a yacht because the yacht log disclosed date of each trip, passengers' names on each trip, and their business association to taxpayer. All expenses fully documented and no trips of a non-business nature were found.
52	Manufacturer	Yacht	$ 75,290	$ 72,070	1953	Taxpayer corporation purchased a yacht to entertain visiting officials of other companies and for rental to its officers below operating costs. The Service charged a portion of the difference to the taxpayer's president as a dividend.
			$114,600	$106,032	1954	
			$ 82,751	$ 74,933	1955	
		Residence	$ 9,600	$ 9,600	1953	Also taxpayer leased from its president his personal residence and automobile to provide food and lodging to its guests when the president was away.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
53	Manufacturer	Tickets for sporting events, etc.	$ 3,000	$ 3,000	1959 & 1960	Most of the expenses claimed were allowed, based on proof by the taxpayer they were connected with his business.
		Convention Bermuda, etc.	$12,000	$11,150	1959 & 1960	
		Gifts	$ 2,000	$ 2,000	1959 & 1960	
		Resort fishing expenses	$15,700	$10,600	1959	
			$10,000	$ 7,200	1960	
		Club dues	$ 8,000	$ 6,190	1959 & 1960	
54	Petroleum Production, Refining & Marketing	Resort Property, Yachts, Apartment, & Entertainment	$104,422	$100,577	1957	Taxpayer company maintained several resort area facilities including several yachts for business conferences, and entertainment. Taxpayer also maintained an apartment used by company employees and representatives. In addition, taxpayer incurred costs for various conventions and club dues to a number of dinner clubs, country clubs, etc, for business purposes. The expense disallowed was a non-deductible capital expenditure.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
55	Dairy	Resorts	$ 90,000	$ 60,000	1957	The taxpayer, a closely held corporation, deducted amounts for sales promotion expenses, including home phone bills, hotel bills for wives of shareholders, resort trips for families of shareholders, racing tickets, etc. The officers engaged in large scale entertaining and kept few detailed records. Three of the officers charged the costs of 17 clubs to the corporation in addition to the costs of 3 yachts, one of which was owned by an officer. The taxpayer maintained that the boats were used for business purposes but no logs were kept to establish this use. Some officers had two company automobiles in their personal possession. Adjustments were proposed for lack of substantiation, considering the presumptively personal nature of the expenses.
		Racing events	$102,900	$ 65,000	1958	
		Clubs				
		Tickets	$106,100	68,000	1959	
		Parties				
		Gifts	$104,400	64,000	1960	
		Yachts				
		etc.				

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
56	Petroleum	Trip to Europe	$12,614	None	1959	Taxpayer toured Europe with his wife to set up a refinery and secure oil leases. No business was actually transacted. Taxpayer claimed deductions for the hotel expenses of himself, his wife, and his daughter, as the basis of discussing oil business or other family business matters. Included in the expenses claimed were purchases of clothes, theatre tickets, drugs, candy, barber and beauty shop treatments, etc. Other deductions claimed were air transportation for his wife and daughter; expenses incurred in the management of his daughter's trust and investments; country club charges incurred by taxpayer and his family allegedly in connection with discussions of business; expenses for the importation of cigars, some of which were given to business associates; expenses for entertainment and meals at night clubs and restaurants during which proposed oil deals were discussed; automobile expenses, many of which were incurred by taxpayer's wife and daughters; and gift expenses, including various and sundry items of small value which the taxpayer himself distributed to employees on special occasions. Taxpayer alleges that all activity outside his home is business motivated, such as seeking investments, discussing oil deals, and looking after his income-producing properties. Disallowances were based upon the revenue agents determination that the claimed deductions had been made for purely personal items to the extent of the disallowed amounts.
		Hotel expense	$15,950	$ 6,500		
		Air transportation	$ 5,812	$ 2,500		
		Country clubs	$ 4,146	$ 2,300		
		Cigars	$ 840	$ 400		
		Night clubs and restaurants	$ 4,500	$ 3,800	1959	
		Car expense	$ 7,500	$ 6,500		
		Gifts	$ 2,000	$ 1,800		

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
57	Independent Oil Operator	Lodging	$ 952	$ 690	1959	Taxpayer's business depends on the ability to acquire bargain properties through his contacts in the oil industry. Taxpayer claimed sums for travel, liquor, hunting and fishing facilities, and club dues. Of these sums expended, taxpayer allocated a portion to business and a portion to personal, based upon his personal opinions. Disallowances were based upon the revenue agents determination that a greater portion of the claimed expenditures were properly allocable to personal rather than business purposes.
		Automobile	$ 3,468			
		Food and beverage for entertaining	$ 5,128	$ 3,211		
		Airplane	$ 350	$ 327		
		Club dues	$ 1,200	$ 750		
		Fishing camp	$ 4,395	$ 2,744		
		Liquor	$ 1,086	$ 558		
		Miscellaneous	$ 828	$ 250		
			$17,407	$ 8,530		
		Lodging	$ 816	$ 647	1960	
		Automobile	$ 3,646	$ 2,000		
		Food and beverage for entertaining	$ 5,920	$ 3,680		
		Airplane	$ 792	$ 685		
		Club dues	$ 1,200	$ 750		
		Fishing camp	$ 4,109	$ 2,562		
		Liquor	$ 1,473	$ 640		
		Miscellaneous	$ 160	$ 100		
			$18,116	$11,064		

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
58	Petroleum Sales	Promotion	$ 7,326	$ 3,663	1958	Taxpayer is a closely held corporation. Taxpayer acquired riding horses which he entered in various shows. Taxpayer's name was listed on the programs, and was displayed on horse trailers and equipment carriers. Taxpayer's return included deductions for board, room, and training of the horses and riding lessons for its president's daughter, who rode them in the shows. Taxpayer's return also included nominal winnings of the horses. Taxpayer claimed the expenses were business connected, but half of them were disallowed. The cost of the horses was treated as a dividend to the president.

SUMMARY ANALYSIS OF TAX CASES INVOLVING DEDUCTIONS FOR ENTERTAINMENT AND RELATED EXPENSES

CASE NO.	TYPE OF BUSINESS	TYPE OF EXPENSE	AMOUNT CLAIMED	AMOUNT ALLOWED	TAX YEAR OR PERIOD	SUMMARY OF FACTS
59	Physician	Entertainment	$ 2,605	$ 1,564	1958	The taxpayer maintained an office in his home. He built an addition to his residence including a recreation hall, barbecue area, and swimming pool, allegedly to promote his practice. No records were maintained to show the business use of these facilities. Expenses were disallowed for the personal use of the facilities by the taxpayer's spouse and social acquaintances.
			$ 2,385	$ 1,400	1959	
			$ 2,648	$ 1,596	1960	
60	Manufacturer	Resorts, conventions, clubs, tickets, gifts, etc.	$23,200	$ 3,700	1958	Taxpayer's expenditures appeared to be largely personal in nature. He was able to establish a business connection only for the amounts allowed.
			$24,700	$ 4,100	1959	
			$23,100	$ 4,000	1960	

- PART FOUR -

Compilation of Current Comments in Newspapers and Periodicals Relating to Expense Accounts and Business Gifts

Permission to reproduce the excerpts in this compilation has been granted by each of the publications concerned.

Treasury Department

FOREWORD

In recent years, the millions of taxpayers who are not so fortunate as to have an expense account and who, incidentally, are the bulwark of our tax system, have been reading and hearing more and more of expense-account abuses. Collected here are excerpts from articles published in magazines, trade journals, and newspapers, which illustrate the public's growing concern with this problem.

The portrait presented by these articles is that of a privileged class which has become known as the "expense-account society" -- a society made up of individuals who, because of the liberality of our tax laws, practically live on expense accounts. According to many of these commentators, there are very few of the necessities of life, such as meals and lodging, or even of the luxuries, such as vacations at fancy resorts, club memberships, and cruises, that such taxpayers cannot somehow deduct on tax returns as business expenses. These articles describe people who can "charge" almost everything to the company; the type of taxpayer who, when questioned about his return, would say "I have no personal life -- all I do is for the company."

EXPENSE ACCOUNTS

The Myth of the Magic Expense Account, Clarence B. Randall, Dun's Review, August 1960, pp. 39-41

. . .

"Certain it is that entertaining by business in this country is now itself big business. Some companies are more widely known for their parties than they are for their products. The occasions for business entertainment range all the way from two for lunch in the executive dining room to several thousand in the ballroom of the big hotel, with name bands, and orchids flown in from Hawaii for the ladies.

"Gone are the days when a salesman occasionally wined and dined his favorite customer, or perhaps gave a small theater party. Nowadays, when the deal gets big enough, the company yacht weighs anchor and moves into position, the company plane takes off for a duck blind in Arkansas, or the best hotel in Miami throws open its doors to expectant dealers for a week of continuous circus.

"The distaff side is cut in, too, on both sides of the deal. How the ladies love it! With jet travel what it is, those who were getting a little tired of White Sulphur may now hope to look in on Capri or the Riviera.

"The unseen partner in all this largesse, of course, the man who rides the afterdeck of the company yacht, co-pilots the duck hunters' plane, sits by while the caviar is spooned out and the crepes suzettes are sizzling, the man who splits the check at the nightspot and hands the big bill to the headwaiter, is none other than Uncle Sam. Lights would go dim along the Strip in Las Vegas and chorus girls would be unemployed from New York to Los Angeles if it were not for that great modern invention, the tax deduction.

"But who are the silent underwriters of this frenetic spending? You and I, the general taxpayers. It is we who make up to the U. S. Treasury the revenue lost through expense-account deductions.

"This orgiastic abuse of the expense account is by no means universal, or even in a broad sense characteristic of our business community today. It is, however, a spectacular and alarming trend participated in by enough companies and individuals to put all of us upon caution for the good reputation of business men as a class.

"So far, expense-account entertainment is held somewhat in check by two factors.

Dun's Review
August 1960

"First of all, the best companies -- those who value the good opinion of thoughtful people -- reject it. They behave with dignity and self-restraint in relationships with their customers.

"Secondly -- and this is altogether discreditable -- in some of those companies that practice excesses, the president himself has no part in it. . . . He just passes the word to the general auditor not to bear down. . . . And the dirty work is delegated to the younger men. . . ."

. . .

"It is disturbing that business does not put its own house in order while there is still time, that it does not speak out boldly against expense-account abuses. The whole purpose of a trade association, or of any nationwide industrial organization, is to provide a collective voice on matters of mutual concern. The trouble is that we use that voice steadily against others, but seldom turn it inward toward ourselves. . . .

" . . . If we cannot correct these things ourselves, we can hardly protest if Government steps in to do it for us.

"But beyond these moral overtones, and the damage currently being done to the good name of business in the eyes of the general public, comes a practical question. Do these practices, in fact, pay off? There would seem to be serious reason to doubt whether lavish display and heavy-handed entertaining are really worth the cost, whether in the long run they actually sell the merchandise."

. . .

" . . . on the law of chances, there are probably as many men who will be offended, even insulted, by over-expenditure to win their favors as there are those who will be impressed.

"Sometimes the use of entertainment and gifts reaches the point where it crosses the line of proper customer relationships altogether and becomes commercial bribery. A set of golf clubs at Christmas to the third assistant purchasing agent, or a carton of cigarettes with a $100 bill tucked inside, is completely venal. Business purchased by such means has too precarious a base to be enduring. . . ."

. . .

Dun's Review
August 1960

"In the long run, the product must sell itself. It takes on no added value from exposure to neon lights, nor is it likely that its special virtues can be explained more clearly at two in the morning than at two in the afternoon. If it is insufficient in quality or uncertain in delivery, no amount of entertaining can long conceal those basic deficiencies. . . ."

. . .

"Objective students of the current business scene must view this phenomenon of the reckless use of expense-account money with considerable dismay. They would be hard to convince that extravagant parties make a significant contribution to the nation. Party or no party, the commodity to be sold remains the same, having no greater utility for the buyer afterwards than before, and no greater profit potential for the seller. To say these things, however, is something of a waste of breath -- for those on the lunatic fringe of industry who commit the excesses are not given to taking serious thought for the welfare of the economy or for the preservation of the private enterprise system in the midst of the great world struggle in which we are engaged.

"They seldom pause to speculate on what image of the American free economy their conduct creates in the minds of men from the new countries who come to study our way of life. From Pakistan to Nigeria, from Ecuador to Indonesia, the battle is on between socialism and free enterprise. Which will be the basis for developing untapped industrial strength? We are the models upon whom men who wish to preserve private initiative in their economies base their hopes.

"We cannot be too careful in what we teach them. They imitate the bad as readily as they do the good, and they may easily attribute our success to the wrong causes."

. . .

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Expense Account Caviar, Lucius Beebe, San Francisco Chronicle, March 20, 1961, p. 36

"If the New Administration in Washington would like to come by a program of readjustment which would evoke rousing cheers from all but a very small segment of the American people, it could hit upon nothing more felicitous than the often promised but never yet actually inaugurated crackdown on executive expense account.

"The expense account society that has been brought into existence by the past attitude of the Treasury toward this aspect of the national business structure is not only one that costs the Federal Government a good deal of money--how much let Sylvia Porter tell you--but is a much resented affront to a great many people who are themselves unable to swell it in expensive resorts, restaurants and foreign travel tax free and out of various corporate pockets on the slim excuse that they are doing company business. . .

"There are precious few Americans of private means who can or will patronize restaurants where the luncheon tab for the chef's suggestion can come to $45 for two, but such plush premises as the Four Seasons in New York are jammed to the reservation desks with expense account patrons paying $200 for dinner for five . . .

. . .

"This is the aspect of expense account civilization that is most distasteful to people of ordinary means and prudent ways with money, even if they have it in ample abundance. Probably corporate expense accounts are the greatest single inflationary agency in the entire national economy, in addition to which well-upholstered jerks pre-empting the best of everything in restaurants, theaters, night clubs and airplanes are a damned poor advertisement for big business. They make more enemies among a class of people naturally sympathetic to corporate vastness than all the radical agitators and socialists put together.

. . .

"An abatement of the expense account society could win the Government wild plaudits from a great many taxpayers who, by indirection, are tired of picking up the tab every time some crumb bum with an executive title, who couldn't treat a friend to a Coke on his own money, decides he wants a week in New York with a suite at the St. Regis and ringside table at El Morocco every evening.

. . ."

Life at Uncle Sam's Expense, The Economist, April 4, 1959, pp. 234, 237

"The maximum tax that an American could be charged by the federal government on his income this year would be 87 percent, but few are so rich and so ingenuous as to be caught in that top bracket. The minimum he could pay depends less on the actual income he receives than on his deftness in charging items off against the expense account allowed him by his employer (who then deducts it from the cost of doing business) or in seeking his own loopholes in the tax laws and ordering his life so as to take advantage of them. Many people do both. Living on an expense account is a recognized technique, loopholes in the law are many; . . .

. . .

". . .The man who dines only at the best restaurants, and takes his clients to see only the most popular plays might, were he paying the full bill himself, persuade his wife to cook supper and then take his guests around the corner to the cinema. But the privilege of writing these gestures off, either on the company's expense account or from his own taxable income, makes a different man of him. He becomes a free spender, bigger than life-size, and headwaiters bow, while the bill is ultimately delivered to Uncle Sam.

"The effect is felt by more than the individual taxpayer. Critics charge that the interaction of expense account habits and income tax rules distorts the price system and weakens the moral fibre of the country. The evidence offered includes such trends as the climbing prices of beefsteaks and theatre tickets, the sea-going convention, and the recently disclosed business interest in ladies whose telephone numbers can be bought."

. . .

". . .The annual convention is of course no novelty. For years these holiday jaunts, masked as educational meetings and therefore properly chargeable to the costs of doing business, have helped to support big resort hotels with convenient golf courses. This year however, the Furness Bermuda Line reports that 26 per cent of its cruise booking in 1959, as compared with 18 percent in 1958, will be convention business. The growing popularity of holding conventions at sea is said to be due to the fact that more members attend educational meetings on board ship just because there are no golf courses attached."

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The Economist
April 4, 1959

"...The Ohio State University School of Journalism recently questioned six hundred presidents of big industrial, insurance, commercial and banking firms on their tax-deductible Christmas giving; under promise of anonymity nearly a quarter of them responded and, with considerable acrimony, some of them described the custom bluntly as 'blackmail' which they could neither approve nor escape. In their world, such gifts ranged from trinkets to Cadillacs, and on to the 'loan of a yacht, liquored, fuelled and girled.' . . . Thus far there is no evidence of a concerted move to end even the most flamboyant of these practices; indeed, no reliable study exists to tell the whole story or to clear the reputation of the business firms which keep free of purple fringes."

<u>High on the Hog</u>, Editorial, The Nation, Dec. 17, 1960, p. 467

"[Business entertainment] no longer gets business, Mr. Auchincloss [lawyer-novelist] pointed out, since everyone 'is perfectly aware that his host is passing the bill onto Uncle Sam in the form of a business deduction.' . . . 'The vice of the system is not in its attempted bribery' said Mr. Auchincloss "but in the privilege of a few to dine and wine at the expence of the taxpayer.' He proposed that Congress disallow the cost of entertainment as a business expense.

"...The racket has reached such proportions that in some cases it is scarcely necessary for a business executive to earn a salary -- he can live like a millionaire on his expense account." . . .

<u>There's no Business Like Lunch Business</u>, William K. Zinsser, New York Times Magazine, March 20, 1960, p. 60

"With expense accounts, many have found they can eat well -- and make money at it.

..."What the country really needs is more restaurants, for that is where much of the nation's business is transacted. The 'business lunch', that lavish exercise in spending the boss's money, has fastened such a grip on our cities that to lunch with someone for pleasure is almost indecent.

. . .

New York Times Magazine
March 20, 1960

". . .Many, in fact, rely on these daily banquets to tide them over the next twenty-four hours. By careful planning, week after week, a man can literally eat himself into solvency. . . .'If he eats on the expense account every day, he saves about $6. That's $30 a week, or $1,500 a year, tax-free--the equivalent of several thousand dollars more in salary,-- . . .Of course, if the man puts in an expense account when actually he went out alone and had a hot dog, he can make $12 a day.'

"This form of chicanery is so common that many a company bookkeeper has been startled to see that two employees took the same client to different restaurants for lunch the same day. Influential columnists believe that they are listed on four or five expense accounts every noon. . . .

. . .

"Presidents of companies do not, on the whole, eat business lunches. . . But in all lower strata, business lunches are almost routine. . . One elderly ad man, asked how frequently he ate on his or somebody else's expense account, looked amazed at the naivete of the question. 'Why, I haven't paid for my lunch' he said, 'in thirty-one years.'"

Expense Accounts, Richard Gehman, Cosmopolitan, March 1957, pp. 44-47

. . .

"Today we live in what has been called the Era of the Expense Account. Ever since World War II, the expense account has been playing an increasingly important part in our lives and our economy. . .

. . .

"The extent to which the expense account has influenced the economy is indicated by the fact that multimillion dollar businesses have been founded and now exist almost solely by virtue of the expense account. The increased traffic in restaurants and in liquor, unusual foods, jewelry, flowers, leather goods, books and other luxury items is directly traceable to the new American habit of blithely charging off nearly everything in sight to expenses.

. . .

Cosmopolitan
March 1957

"Food, drink and expensive gifts are not the only items that turn up regularly on expense accounts. Some men also feel justified in putting down upkeep of their homes, entertainment in their homes, clothes for their wives, and services provided for business associates--services such as furnishing chartered planes or railroad cars, limousines and chauffeurs, or supplying private secretaries complete with typewriters and dictating machines . . .

". . .Giving expense accounts to its salesmen and executives has three distinct advantages for a corporation.

"First, it saves money. Most larger companies now pay a 52 percent corporate tax. When a salesman spends a dollar in attempting to cajole a customer into buying the company's product, it actually costs the company only forty-eight cents. . . .

"Second, it enables the company to reward or remunerate its employees without making them subject to further personal income taxes . . .

"Third, it enables the company to get more work out of its employees. The man who has no expense account works a given number of hours each day; his evenings are free. The man who is expected to entertain clients and prospects usually does it after business hours . . .

. . .

"But the expense account economy does not work exclusively to the benefit of the large corporation. The small businessman may benefit from the structure of the tax laws, too. By incorporating himself, even the man with a modest income can live on a scale comparable to that of a maharajah. . .and, in general, enjoy himself at the government's expense . . .

". . .Actually, the expense account has created a new upper class--a group of men who, while paying themselves relatively small salaries, actually can live as though their incomes equaled those of oil barons.

" 'Expense account spending first reached a peak during World War II,' says a Pennsylvania manufacturer, . . .in my opinion, it's helped contribute to inflation, by jacking up prices far out of reason.'

. . .

Cosmopolitan
March 1957

". . .Under the expense account economy, human behavior is sometimes subjected to severe stress.

"'I've known of several cases in which an expense account at the office caused trouble in the home,' says an advertising agency executive. He points out that a young man who takes clients to the Colony, Le Pavillon, and other high-priced restaurants for lunch, merrily charging the $35-for two tabs to his company, leads a schizophrenic existence . . .

"Unless the young man's moral fiber is stronger than most men's, he is bound to react unfavorably. So is his wife; at lunch, munching a cheese sandwich, she cannot be blamed for thinking bitterly of her husband, at that moment eating pheasant in Twenty-One. She is bound to be jealous; she is bound to demand to be taken along on his expense account sprees. . .

"The expense account may cause other domestic difficulties . . . the husband and wife may actually find themselves living on a higher standard than they can afford.

. . .

". . .Many people who operate on expense accounts augment their incomes by falsifying. It is not uncommon for a man, signing a tab in a restaurant where he is known, to put down an amount double the size of the check and take the remainder of the money for himself . . .

<u>We're Meeting in Siam</u>, Bring the Wife, Eugene D. Fleming, Cosmopolitan, May 1960, p. 60

"Ever see a business meeting on a tropical beach? Or a million-dollar contract signed at a cocktail party? Or a salesman's wife taking part in company policy? Conventions in exotic places are the newest travel bonanza. Best of all, the cost is tax-deductible.

"Day in and night out during 1960, from the Roosevelt Hotel in Cedar Rapids, Iowa, to the sunbaked villas of the Italian Riviera; at millionaire playgrounds in the Caribbean, such as Laurence Rockefeller's elegant Dorado Beach Hotel; on board luxury cruise ships; and at world-famed spas like French Lick, Indiana, whose two golf courses and three pools make thinking less fatiguing, some sixteen million Americans from every walk of life--salesmen, executives, horticulturists, railway surgeons--will be discussing common problems, making valuable contacts, closing multimillion-dollar deals--and drinking like the well was going dry.

. . .

Cosmopolitan
May 1960

"Ten million of these travelers are freely associated joiners who attend over twenty thousand get-togethers, ranging from that of the American Medical Association to the Concatenated Order of Hoo-Hoo, a national lumberman's fraternity. In addition, six million businessmen fly hither and yon to sop up corporate wisdom (among other things) at over sixty thousand company conventions. These steadfast pursuers of conclaves spend well over a billion dollars on convention-going travel alone.

"Convention travel, it seems, knows no bounds. . . . Delegates would certainly rather spend a week in Paris than in Chicago, the reasoning goes. The travel time is only a difference of hours and just as tax-deductible, so why not meet there? Bring your wife, of course. She'll love it."

<u>An Unknown Side of Resource Allocation, the Invisible Hand of Tax Exemption</u>, Norman B. Ture, Challenge, November 1960, pp. 8-10

. . .

"The tax treatment of expense accounts is about the most thorny problem in the income tax. The typical situation which causes so much furor involves a company's sales representative who spends lavishly in an effort to secure or retain a customer. Caribbean cruises, theater tickets, a season's box at sporting events, expensive gifts, are a few examples. For a company's executives, there may be country club memberships, use of the company's cars, hunting lodges, perhaps even a home -- all at the company's expense.

"Entertainment expenses which show up on the expense account often include those incurred on behalf of the employee's wife and the spouse of the prospective customer. Exciting journeys with gun and camera through what used to be darkest Africa show up on the company's tax return as sales expenses. The cost of the boss' honeymoon has been known to appear in the same way.

"To the extent that these expenses are allowed as deductions, the government -- therefore, all of us -- pays the bill for the goods and services provided for the employee, his sales prospects and others loaded into his expense account. Those on the receiving end do not include the value of these goods and services in their taxable income.

"The company, in other words, is allowed a deduction for a cost of producing income, but the recipients of these expenditures do not report them as income. This creates an anomaly. Though what is cost to one economic entity (in this case the company) <u>must</u> be

Challenge
November 1960

income to some other (in this case the recipient), this is not always so from the point of view of the federal income tax.

"Why not just disallow all such deductions? If this were done, clearly this type of sales promotion would cost the company considerably more. With the present corporation income tax rate of 52 per cent, every deductible dollar on an expense account costs the company only 48 cents. Remove the deduction and the cost shoots up -- a dollar of expense is then a full dollar of cost.

"Where should the line be drawn? The statute's 'ordinary and necessary' rule for deductions is not much help in many cases. What is ordinary in one line of business is frequently extraordinary in another. In fact, the courts interpret 'ordinary' to mean not unique in the business community -- rather than customary in a particular business. On this basis, it is hard to conceive of an expense which could not qualify as ordinary.

"If 'ordinary' won't do as a criterion for deductibility, what about 'necessary'? Necessity might seem to be an easier test to apply. But how should one distinguish between the legitimacy of an expense and the necessity for it?

"The African safari, for example, had a legitimate business purpose; it did indeed contribute to sales promotion, or so it was ruled. Was it necessary, however? Most of us would answer, unhesitatingly, that it wasn't. But what kind of objective criteria are we to use in deciding that the expense of this trip was not as necessary as an equal expenditure on some other activity which produced the same effect on sales?

"Because of these difficulties in applying the vague language of the Internal Revenue Code, this kind of sales promotion effort meets with extremely liberal tax treatment. This situation encourages the allocation of a greater volume of resources to lavish sales promotion methods than would otherwise occur. Moreover, this result was not contemplated when the Internal Revenue Code was framed.

"The frivolous -- and well-publicized -- activities for which tax deductions are claimed, offends Congressmen and Senators just as greatly as novelists and TV scenario writers. The apparent disinclination to amend the tax law in this area, however, does not imply approval of its results. It is rather, evidence of the difficulties in making a change which will conform with legitimate business requirements." . . .

<u>I'll Just Sign</u>, Those Big-Figure Expense Accounts, Newsweek, May 20, 1957, pp. 87-92

"While U. S. prosperity rests on a solid base of production and sales, its facade is brightened considerably by a host of 'deductibles'--the appurtenances, from first-class fares to crepes suzette, that many employes can rarely afford on their own incomes but can enjoy when traveling on an expense account.

. . .

"Nothing on the U. S. business scene has provoked more elbow digs and thigh-slapping than the expense account, including racy bits about traveling salesmen who are among its chief devotees.

. . .

". . .More people are spending more money on the company cuff than at any other time, at a rate that would astound 'swindle-sheet' artists of a decade ago.

. . .

"Some 80 percent of luncheons served at top Manhattan restaurants like '21' Le Pavillon, and Chambord . . .are expensed. On the Florida Gold Coast, expense accounts are the backbone of the winter economy. . .Without expense accounts, big yacht basins like Fort Lauderdale's Bahia Mar might be almost deserted.

<u>The Conventions--Work, Hard Play</u>, Business Week, May 16, 1959, pp. 176-182

"Last week some 200 members and guests of the Magazine Publishers Assn. spent three days luxuriating at The Greenbrier, posh resort hotel at White Sulphur Springs, W. Va. (pictures).

"What drew them was MPA's 40th annual spring meeting--plus the golf, tennis, swimming, fine food, and secluded luxury that ever since the war have been luring an increasing share of conventioneering Americans to the resort hotels. . .

". . .The American penchant for conventions--increasingly bearing the more elegant label of conferences--has reached its de luxe flowering in these rural spas that once were the exclusive domain of wealthy families and dowagers who are moving over for the growing number of expense-account guests. . . .

Business Week
May 16, 1959

". . .When the resort hotels--safely secluded from the hurly-burly of the metropolitan areas--got into the convention business they introduced a new note. The flamboyance and commercialism of many of the older shows was replaced by a few days of luxurious living, spiced with refined business contacts and high-level formal programs. Business deals, to be sure, are sometimes started or even concluded, but such trafficking is frowned on except in private, friendly conversation.

"This special type of resort hotel convention is the elite one. . . And the gatherings are kept smallish both by the limits of the hotel's facilities and the fact that they draw mostly from higher, bigger-expense-account echelons of business.

". . .The Magazine Publishers' confab at The Greenbrier last week was thoroughly typical of the resort hotel convention. The MPA devoted the first day to committee reports and pressing industry problems. In the evening, special committees met.

"For the rest of the time, it was half work, half play. . .

". . .The talks--serious, sometimes valuable and interesting--serve as a psychic payoff for the enjoyment of the other half of the meeting--the hard play in the afternoon. This conscience factor helps account for the remarkably high attendance at formal meetings. . . .

<u>Visit to the World of Expence Accounts</u>, Russell Lynes, N. Y. Times Magazine, Feb. 24, 1957, p. 17

. . .

"The expense account--its wry pleasures, its hangovers, its bonanzas and its abuses--has become one of the uneasy national jokes of our time. . .

". . .Since not all of us can sink oil wells and have a benign Government smile on our profits and bemoan our losses, we find ways of charging our appetite for luxury to 'the company,' which, in the final analysis, is charging it to our neighbors' tax bills." . . .

. . .

"A system of rewards is obviously essential to the successful operation of the capitalist system. The trouble, if it is a trouble, is that the rewards that are represented by the private use of the company plane, the company car and the company shooting lodge do not seem like rewards for performance; they seem to a great many people like special privilege, and that, in a very real sense, is what they are meant to look like." . . .

N. Y. Times Magazine
Feb. 24, 1957

. . .

". . .the tax structure seems to create one ethic for certain business men whose services are greatly in demand by corporations and another for the rest of us." . . .

"Seen from a distance, the group portrait of expense-account society presents a rather curious picture. . .To a great many people it inevitably looks, and will continue to look, like the society of kept men."

Expense Account Scandal, U.S. News & World Report, Jan. 25, 1960, pp. 50-54 (Copyright 1960)

. . .

"An expense-account scandal--1.5 billion dollars in size--is starting now to get special attention from this country's tax collectors.

"The scandal grows out of the use of business-expense accounts to evade taxes by hiding taxable income. Income that should be taxed, but is not taxed, is estimated at 1.5 billion dollars or more a year. Tax loss is reported to exceed 700 million a year.

. . .

"One of the partners in an accounting firm comments: 'I don't think the Internal Revenue Service is exaggerating the extent of the expense-account scandal. There isn't any doubt that the total of money being taken as tax deductions is enormous.'

. . .

"Phony branch offices. A growing practice, tax men say, is for a small firm to maintain an unused office as a 'front' in a resort area. This gives executives an excuse to deduct travel expenses for visits ostensibly made to the branch office. Actually, these visits can be a cloak for personal vacation trips.

. . . ."

"BUSINESS" GIFTS

Printers' Ink, Sept. 2, 1960, pp. 44-45

"During World War II the sharp rise in the regular corporate income tax rate, capped off for a time by an excess-profits tax, had brought industry's generosity, largely at Uncle Sam's expense, to an all-time high.

"Now a reaction, quiet, but all pervasive, has set in. The regular tax rate is still high, and our Treasury still picks up most of the tab for corporate gifts, but there is a difference. The change in attitude and practice is really a product of the times. . .

"Two effects have been notices. One is the decision by some companies that they will not permit their employees to accept any gifts at all or, in some cases, any gifts of more than nominal value. Some businesses have stopped giving gifts to customers. In other instances, some former gift-givers have replaced their largesse to individuals with donations to charity in the name of business friends.

. . .

"Corporate gift-giving is conducted on a scale estimated to have grown from $200 - million in 1950 to almost a billion dollars this year, with the average cost per gift now about $7 . . .

"What the corporate gift buyer must do now is try to find a middle defensible ground between the lush gift that has caused so much public eyebrow-raising and the gift with so little intrinsic value that it would stip up more ill will than good will in the mind of the recipients." . . .

Spirits, Oct. 1960, pp. 13, 40

"Over one billion dollars, or about 10 percent of all expenditures for alcoholic beverages in the United States may come out of the corporate treasury . . .

. . .

"As for gift buying, the every-man-for-himself land of estimate has to be entered once more. Sales Management, 'the magazine of marketing,' which surveyed 900 American industrial companies in spring-summer, 1960, about their gift giving proclivities, put it succinctly when it said:

Spirits Oct. 1960

'In the absence of exact reporting, marketers must guesstimate the national gift-incentive volume. Esquire puts it at $2.5 billion dollars. (The people over at Fortune set the entire market at $2.2 billion.) The Business Goodwill Advisory Council is more cautious' the SM report continued,--'Almost $300 million, not counting liquor and purchases at retail stores.'

". . .'the international news magazine for sales and marketing executives,' has stated that 'Today corporate gift-giving adds up to a $300-million industry at Christmas time.'

. . .

". . .'Industrial and commercial buying apparently fell off to some extent primarily because of the 'payola' scandals that rocked the nation.'

. . .

". . .It is clear that there is a reaction to business entertainment, if only through a few voices.

"It is also clear that there is an 'expense-account audience' that helps pay the distiller's bills to the tune of hundreds of millions of dollars each year . . ."

The Reporter, Dec. 25, 1958, pp. 20, 21

. . .

"During a year-long study recently completed by the School of Journalism at Ohio State University, the presidents of the country's five hundred largest industries, fifty major merchandisers, fifty big insurance companies, and fifty biggest banks were polled. . .

"Nearly a quarter of them replied. They spoke their minds in the bluntest of blunt language. They used words like 'blackmail' and 'sucker' and 'shakedown.' They told of gifts ranging from trinkets to Cadillacs to $280,000 in cash to 'the loan of a yacht--liquored, fueled, and girled.'

. . .

". . .Nearly half of the big industrialists say their companies give to customers, suppliers, prospects, public officials, newspaper people, and others. Yet seven out of ten don't like the idea. (Six of ten flatly disapprove, one out of ten has serious misgivings.)

The Reporter
Dec. 25, 1958

"Why this difference between what companies do and what their presidents believe in? Very simple: money. Nine out of ten say they give 'for business benefit' or to 'meet competition.' The tenth gives as a gesture of good will . . .

. . .

". . .What is the most expensive gift--which you personally know about--that any company has given to gain a benefit?' the company presidents were asked. Examples of their replies:

"Midwestern appliance dealer: "A trip to Jamaica."

"Oil refiner: 'Fifteen shares of stock, cost $3,500. . .'

"Heavy-equipment manufacturer: 'Cadillac to get shipping contract.'

"Ore producer: 'Boat trips and other gifts, $4,000 to $5,000.'

"Life-insurance man: "Trip to Europe.'

"Ore refiner: 'Furnace for a brand-new house.'

"Mentioned most often were hi-fis, television sets, automobiles (with Cadillacs far outnumbering other makes), cases of whisky, fancy luggage, trips, hotel accommodations, and lavish entertainment. . .

. . ."

Fortune, Editorial note, Oct. 1959, p. 108

. . .

"And does the business gift really express the spirit of Christmas? Since everybody knows it is written off as a business expense, its qualification as a token of affection or esteem would seem to be highly dubious. In any case the practice is a nuisance, and can turn out to be a source of embarrassment to both sides . . ."

Business Record, Nov. 1959, pp. 503-508

"Giving Christmas gifts to customers and other business friends is a practice that most of the 291 manufacturing firms participating in this month's survey of business practices strongly oppose in principle. Typical is the attitude of one construction materials producer who regards 'the giving of Christmas gifts for business purposes as a most unhealthy practice, which in its worst form borders on bribery, and in its lesser form is a useless business expense.'

"Even more outspoken in his disapproval is one company president who states that 'the giving of Christmas gifts on the part of business is becoming a racket, and we shall do everything we can to discourage it.'

"To the extent that business gifts 'are intended to influence the placement of an order, they are a source of embarrassment to the recipient,' according to respondents. . .

. . .

"A small minority of the firms surveyed maintain that there is nothing inherently wrong with the practice of Christmas business gifts.

. . .

"Another group of companies, while agreeing with the sentiment of business Christmas remembrances, replies that 'our Christmas greetings to customers are very well expressed through the medium of a Christmas card.' . . .

. . .

"While most responding companies would prefer not to participate in giving or receiving business Christmas gifts, almost half do send out gifts at Christmas time. Considerations of precedence and competition are most often cited by respondents to explain their continuation of Christmas giving, . . ."

. . .

Sales Management, Sept. 10, 1959

. . .

"How 448 companies spent their gift dollars

Up to $2.	4.4%
$2.01 to $5	11.0
$5.01 to $10.	62.3
$10.01 to $20.	7.6
$20.01 to $50.	5.5
More than $50	9.2

. . .

"When does a gift become a bribe?

. . .

"Sales Management's Eighth Annual Survey put this question to 758 executives . . .

. . .

". . .385 respondents set down a dollar dividing line. Below that mark, they believe, business gifts are friendly remembrances. Above it lies extravagance and bribery.

. . .

". . .The 385 specific amounts and number of mentions divided into:

$5-$10 -- 28

$5-- 49

$10--113

$10-$15-- 18

. . ."

American Lumberman, Nov. 24, 1958, pp. 62, 80

• • •

"Cash to contractor's favorite charity is replacing loot to individual builders. Dealers give new views on holiday gift problem."

• • •

"Who killed Santa Claus?

"That is a question that some contractors may be asking themselves next month. More and more dealers say they are getting awfully tired of the insiduous seasonal shakedown commonly known as the Christmas gift.

"A coast-to-coast check of dealers by American Lumberman indicates that many dealers are gradually calling a halt to promiscuous gifts to contractors at the holiday season.

"Adverse dealer comments on gift-giving ranged from 'a necessary evil' and 'parasitic expense' to 'vicious cycle, which should be brought to a stop.'

"Most dealers admitted that they go along with the idea of gift-giving simply because it is expected. Other dealers feel more strongly."

• • •

"Eliminating gifts to contractors wouldn't hurt their business a bit, several dealers predicted, admitting that once started, gift-giving is a hard practice to stop."

Purchasing Magazine, Dec. 1957, pp. 75, 76, 77, 328

• • •

". . . 75.6% of the P.A.'s [purchasing agents] and 76.0% of the sales managers would 'like to see gift-giving eliminated entirely'."

• • •

". . . The fact is gifts are a waste of money in many cases. Although half the sales managers surveyed said they bought gifts for their customers, less than 20% of them believed sales and earnings would be hurt if they cut out the practice. In other words, over half the companies that give gifts to customers don't do it on an economic basis. . . ."

Purchasing Magazine
December 1957

. . .

"Just about everyone in sales and purchasing agrees that a really big gift -- particularly cash -- is, in effect a bribe. . . ."

Business Week, Nov. 28, 1959, pp. 161, 162

"This is the time of year when the question of giving Christmas gifts to business associates often crops up.

"It's always been a ticklish problem, but made doubly so this year because of the current scandals concerning 'Payola' and business bribes in general. For in making a Christmas gift, the question is often raised whether the gift isn't really made for services rendered or anticipated.

"That's one reason quite a few business executives don't accept such presents and a growing number of businessman simply don't give business Christmas Gifts."

. . .

Time, Dec. 1, 1958, p. 74

"Hardly anyone anywhere celebrates Christmas more impressively -- or does retailers more good -- than the U. S. businessman. . . . The list has grown so long that today the Santas-in-pinstripes spend something like $1 billion on yuletide cheer: $300 million for liquor, the rest for a stockingful of loot ranging from $2.50 puddings to $2,500 pianos. The giving is not necessarily due to an excess of Christmas spirit; businessmen simply think that they must. . . . 'Giving business Christmas presents is like drinking at lunch. Nobody wants to, but everyone's scared not to.' Now at last, the tide is turning. The company Christmas present, like the office party, is on its way down."

. . .

"Companies have found that the present produces some king-sized headaches. . . . some companies spend $100,000 or more on gifts alone each Christmas."

. . .

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EXHIBIT VI

GAIN ON SALE OF DEPRECIABLE REAL ESTATE

A. Excessive Tax Allowances on Depreciable Real Estate and Recommended Remedial Action

B. Examples of Cases in which Real Estate was Sold after Depreciation Allowances had Substantially Exceeded Actual Decline in Value

C. Example of Relationship Between Depreciation and Nontaxable Cash Flow in a Typical Projection

D. Analysis of Real Estate Corporation Prospectuses

E. Projections of Cash Flow and Taxable Income by Noncorporate Real Estate Syndicates Based on Actual Prospectuses

EXHIBIT VI

GAIN ON SALE OF DEPRECIABLE REAL ESTATE

A. Excessive Tax Allowances on Depreciable Real Estate and Recommended Remedial Action

The allowance of excessive depreciation deductions for real estate is a defect in the existing tax law which results, on disposition of the property, in an overstatement of gains. Under existing law, a taxpayer deducts depreciation from ordinary income, but pays tax upon gain from sale of the property at capital gains rates. In those cases in which the allowances for depreciation exceed the actual decline in economic value of the property, the taxpayer is permitted, in effect, to convert ordinary income into capital gain. This advantage is compounded by the fact that the acquisition of real estate is usually financed by a mortgage on the property, and depreciation deductions are allowed on an amount equivalent to the indebtedness as well as the taxpayer's equity investment. These large depreciation deductions permit the tax-free amortization of the mortgage to which the property is subject. They also permit a substantial tax-free cash return on the investment and frequently they enable the taxpayer to show a loss from year to year which he may offset against other ordinary income which would otherwise be subject to tax at the taxpayer's top marginal tax rate. To deal with this situation the President recommended that capital gains treatment be withdrawn from gains on the disposition of depreciable real property to the extent of prior depreciation allowances.

Straight-line Depreciation more Appropriate for Real Estate

As an alternative to resting entirely on full recapture at time of sale of the excessive depreciation which is almost invariably present in the case of sales of real estate, it is recommended that there be at least a limited recapture, as described below, and that depreciation with respect to depreciable real property hereafter acquired be limited to an amount not in excess of the depreciation allowed under the straight-line method. Experience has demonstrated that the accelerated methods of depreciation being applied to real estate produce, in general, unrealistically high deductions.

Restriction of real estate depreciation to the straight-line method of depreciation is supported by (1) the realities of real estate finance and the views of the real estate investing public as to actual economic depreciation suffered and (2) technological and economic distinctions between depreciation of machinery and real property.

1. The realities of real estate finance

Evidence that the accelerated methods of depreciation are unrealistic as applied to real estate is found (a) in the great disparity between the rate of depreciation under the accelerated method and the rate of amortization of real estate mortgages typically required by lenders of money, and (b) in the fact that hundreds of millions of dollars are annually invested in real estate securities on the basis of projections showing negligible or extremely small net income for tax purposes. In this connection see the taxable income projections in the prospectuses of eleven real estate corporations in Part D of this exhibit, and the projections in prospectuses of several real estate syndicates in Part E. The role of depreciation in real estate investment today is illustrated by the following example, based on figures cited in 1955 by Miles L. Colean, a real estate expert and investment consultant, in articles explaining the tax saving potentialities of the accelerated depreciation method. 1/

Example

A builder buys for $100,000 a site on which he constructs a building at a cost of $900,000. The building produces gross earnings of $150,000 a year and a net income of $82,500 after all operating expenses but before depreciation and mortgage interest.

The investment is financed with an $800,000 mortgage at 4-1/2 percent interest and amortized over 30 years. The builder's own investment is therefore $200,000.

The mortgage interest payments over the first five years would be $172,500; the mortgage amortization in the same period would amount to $70,900.

The double-declining balance method of depreciation based on a 40-year life or 5-percent rate would provide income tax deductions totaling $203,600 over the first five years. Straight-line depreciation would provide $112,500 deductions.

1/ Miles L. Colean in series of articles entitled "Realities of Today's Real Estate Investment," particularly Part II "The Role of Depreciation," Architectural Forum, April 1955.

Results of the investment over a five-year period under double-declining balance and straight-line depreciation are compared below.

	(5 year total) Double declining balance	(5 year total) Straight line
1. Operating income before interest and depreciation	$412,500	$412,500
2. Less: mortgage interest	172,500	172,500
3. Net income before depreciation	240,000	240,000
4. Less: depreciation	203,600	112,500
5. Taxable income	36,400	127,500
6. Mortgage amortization	70,900	70,900
7. Available for tax-free dividend (item 4 minus item 6)	132,700	41,600

These figures, designed to show the attractiveness of a good "deal" for the real estate investor, demonstrate the implausibility of the accelerated depreciation as a realistic measure of loss of economic values in this situation.

In the first place, it implies that the value of the property, originally $200,000 in excess of the mortgage loan, would in the first five years decrease by nearly three times as much as the unamortized loan principal. Similarly, as is shown in the following table, it implies that the value of the improvement alone, originally $100,000 in excess of the loan, would shrink to $32,700 below the unamortized loan, and that the over-all margin of security by which the collateral exceeded the outstanding loan would be reduced by two-thirds.

	Net book value	Unamortized loan	Excess of book value over outstanding loan
Year 1			
Building only	$ 900,000	$800,000	$100,000
Building and land	1,000,000		200,000 (25.0%)
Deduct: 5-year depreciation and loan amortization	-203,600	-70,900	-132,700
After 5 years			
Building	696,400	729,100	- 32,700
Building and land	796,400		67,300 (9.2%)

Use of double-declining balance depreciation in this situation implies that the net income before tax on a $200,000 equity investment in an essentially attractive deal is, roughly, 18.2 percent for all five years as a whole (36,400 ÷ $200,000) or about 3.6 percent annually. On the straight-line depreciation method the five-year rate of return is 63.8 percent or 12.9 percent annually, which is a much more realistic rate of return to expect on equity investment before income tax.

These computations assume that none of the investor's initial equity is withdrawn. Since, however, the funds available, in addition to taxable income, after payment of all operating expenses, interest and amortization, were withdrawn as a tax-free return of the original equity investment, by the end of the sixth year the taxpayer's remaining investment in the property is less than $50,000. In other words, by the end of the sixth year more than three quarters of his original investment has been returned to him. At this point the taxable income of approximately $15,000 represents a rate of return of about 30 percent per year on his remaining investment.

The double-declining balance depreciation in this case amounted to 2.9 times the mortgage amortization over the first five years in spite of the fact that the depreciable life used was one-third longer than the term of the mortgage and the original loan was almost 90 percent of the original depreciable basis. Even straight-line depreciation would have been 60 percent higher than the loan amortization requirements.

The depreciation allowances projected in the kind of deals illustrated here are not regarded by real estate experts as a realistic cost reflecting capital usage and obsolescence. The allowances are regarded as a source of tax-free dividends or cash flow whereby the property may be milked prior to its resale to re-establish a basis in line with its true value. Actual depreciation is substantially less than these allowances. As was stated by Mr. Mark H. Johnson, a recognized authority on Federal taxation and author of standard works on the subject, in testifying at the hearings before the Ways and Means Committee on the President's 1961 Tax Recommendations (Volume 2 at page 1247, "* * * it seems to be accepted in the real estate industry that depreciation is measured by mortgage amortization -- the amount that you have to pay off on the mortgage, by and large, is considered about equivalent to current wastage of asset."

2. Technological and other distinctions between buildings and productive equipment

Buildings, like other depreciable assets, are subject to wear, tear, decay, and deterioration, which ultimately result in retirement

after a period of years. The process is much slower, however, in the case of a well-constructed and adequately maintained building than it is in the case of machinery and equipment. Moreover, it can be substantially compensated for by periodic repair, renewal, and replacement of particular parts.

Obsolescence may affect buildings as it does equipment. Experience demonstrates, however, that obsolescence of good buildings is comparatively slow and has not increased in recent decades in the same way as obsolescence of equipment. For a building, any hazard of obsolescence due to change in neighborhood is thoroughly predictable for the early years after construction or acquisition. The rapid technological changes in electronics, automation, and production machinery do not equally affect real estate. The components of a building which may be affected (heating, air conditioning, lighting, electrical conduits, elevators, etc.) may be renewed or replaced without the building becoming obsolete. As long as production, commercial activity or residential needs require enclosed space, a sound building is not likely to become rapidly obsolete.

Moreover, there is no indication that a building suffers rapid fall-off of value in the early years of its existence. The contrary appears to be true. The value of a building tends to be sustained and may even rise during its early years, as tenancy and reputation become established, initial technical defects are eliminated and smooth operating conditions are developed. Some real estate experts believe that in view of the remaining value of a building from year to year and the generally accepted timing of mortgage amortization, the annuity or sinking fund method of depreciation, with low depreciation in the early years and increasing depreciation in later years, would be appropriate for real estate. According to this view, even the straight-line method provides too rapid a write-off for real estate investments.

It is clear that there is no recognized pattern of loss of the value of buildings which corresponds to patterns established for certain machinery and automotive items that would justify the accelerated depreciation methods for buildings. As real estate promoters have pointed out, actual depreciation is of relatively little consequence for the real estate investor who plans to resell and reinvest in a newer promotion within a few years. Yet this is the investor who benefits most from the accelerated methods.

When the Congress originally adopted the faster depreciation methods in 1954, no distinction was drawn between tangible personal property and realty, although the general tenor of the Committee

reports strongly suggests primary concern with depreciation policies on machinery and equipment to assist industrial modernization and to aid small businessmen and farmers who are dependent on earnings and short-term loans for expansion. It was emphasized that the objective was to provide a realistic timing pattern, not an unsound or distorted rate of write-off. In explaining the reasons for the denial of the new methods to used assets in particular it was indicated that the Committees were adverse to use of the new methods in ways which might artificially encourage transfers and exchanges of partially depreciated assets motivated only by tax considerations.

The Senate amendments in 1954 to permit the switch from double-declining balance to the straight-line method and use of the sum-of-the-years digits method reflected concern that full recovery of costs over the life of the asset should be assured, after allowing for realistic salvage. The amendments were designed to meet the requirements of the taxpayer who buys an asset to use over its full service life, not one who would skim off the cream of the liberalized depreciation in the early years and then pass the asset on to another taxpayer who would re-establish its basis in line with its actual value and depreciate it all over again.

The legislative history indicates that the intent of the Congress was to afford a more realistic timing of depreciation with proper recognition of early obsolescence, primarily in the machinery and equipment fields, and to adjust the timing for writing off capital costs of businesses which genuinely used up their assets in their operations.

There is considerable turnover of some types of equipment. The mobility and relatively low transfer costs for automobiles and trucks make resale transactions readily feasible for this type of equipment. On the other hand, the fact that such assets are acquired and disposed of on a group or mass basis, establishing regular patterns of business policy, permits checking unintended abuse of the fast depreciation methods in their case.

Real estate is readily transferable without excessive costs in a way that factory production line machinery and equipment are not. Real estate has a broader market than most specialized equipment and transfer costs are limited to legal fees and brokerage. Moreover, a real estate transaction typically involves a specific property with some distinct characteristics, so that checks on excessive depreciation in relation to consistent resale practices cannot readily be applied administratively.

Although the 150 percent declining-balance method of depreciation was permitted with respect to used real estate under the 1939 Code by a ruling issued in 1946, its use was very limited. With the adoption of the accelerated methods in 1954 attention was focused upon the possibilities of generating "cash flow" in the early years of depreciating an asset under an accelerated method. Since that time increasing numbers of real estate offerings, public and private, have been made in which heavy emphasis has been given to the special advantages of the favorable tax depreciation rules. While these offerings were originally limited primarily to the real estate syndicate, more recently they have been made by real estate corporations and since 1960 by real estate investment trusts. A recent survey of some of these transactions shows that for 1959, 1960, and 1961 there were 25 offerings registered with the Securities and Exchange Commission by so-called "cash-flow" companies involving over $300 million. In New York alone, over $1 billion of real estate securities were offered in 1961.

Modified Recapture Provisions

In addition to the foregoing proposal to make the accelerated methods of depreciation inapplicable to real property, it is recommended that gain on the sale of real property be treated as ordinary income to the extent of depreciation for taxable years beginning after December 31, 1961, such ordinary income treatment to be subject to a sliding scale cutoff as follows: In the case of real property held for six years or less at time of disposition, gain would be ordinary income to the extent of 100 percent of such depreciation. In the case of real property held for more than six years prior to disposition, the percentage of such depreciation which would be treated as ordinary income would be reduced by one percentage point for each month the property has been held in addition to six years. Thus after 14-1/3 years, none of the gain would be treated as ordinary income.

Such a limited recapture will help with enforcement in three difficult areas involving real estate by reducing the significance of errors in: (1) the determination of useful life; (2) the determination of whether repairs should be currently deducted or capitalized; and (3) the determination or allocation of purchase price between land which is nondepreciable and the improvements thereon. Since examination of cases involving sales of real estate in recent years reveals many instances in which straight-line depreciation has been in excess of the actual decline in value and the straight-line method can be and has been used to generate nontaxable cash flow in the early years after acquisition, a limited recapture will help to limit the use of the depreciation deduction to convert ordinary income into capital gain, without being subject to the same criticisms that apply to unlimited recapture.

On the other hand, it is clear from examination of current real estate practices that a limited recapture, such as is recommended here, without the removal of the accelerated depreciation methods for real estate, will not eliminate the present abuse of the accelerated methods in the real estate area. The effect of a limited recapture without removal of accelerated depreciation would be to cause those investors who now plan to sell after seven or eight years to defer the sale until most of the gain is no longer subject to recapture. The tax benefits of holding property for 15 years are readily apparent when it is considered that at that point a property with 30 years of useful life has been 64.5 percent depreciated under the double-declining balance method, whereas such property would have been only 50 percent depreciated under the straight-line method. Without the removal of the accelerated methods of depreciation for real estate, a full recapture as proposed last year would be necessary.

B. Examples of Cases in which Real Estate was Sold after Depreciation Allowances had Substantially Exceeded Actual Decline in Value

Examples of a few of the many cases which have come to the attention of the Internal Revenue Service in which depreciation allowances with respect to real property have exceeded the actual decline in economic value, followed by sale in which gain reflecting such excessive depreciation is realized, follow.

Example 1

Hotel

In 1953, Corporation A acquired a hotel at a cost slightly in excess of $13 million of which approximately $2 million was attributable to land. After three years, the property was sold for $20 million, for a profit of $9,500,000, a substantial portion of which was attributable to the building. During the three-year period, the taxpayer had taken a little over $2,700,000 in depreciation allowances. Thus, almost $3 million of the gain on the sale of this property is represented by depreciation deductions which had been taken against ordinary income.

Example 2

Store and Office Building

In 1953, Corporation A acquired a piece of real estate with a store and office building thereon at a cost slightly in excess of $1 million. Over one-half of the cost was allocable to the land.

After deducting a total of a little over $174,000 depreciation, the property was sold in 1959 for $1,150,000 for a profit of $219,000. All of the gain attributable to the depreciable portion of the property, approximately $100,000, is represented by excessive depreciation deductions.

Example 3

Office Building

In 1953, Partnership A acquired an office building for approximately $925,000, took as deductions for depreciation $192,000, and sold the property in 1958 for approximately $973,000. Approximately one-third of the cost was allocated to the land. All of the gain attributable to the depreciable portion of the property, approximately $140,000, is represented by excessive depreciation deductions.

Example 4

Hotel

In 1955, Corporation A acquired a hotel on leased land for $1,965,000. After claiming depreciation in the amount of $197,000, the hotel was sold in 1956 at a gain of about $1;390,000. Since Corporation A realized such a large gain it is clear that the entire first year's depreciation of approximately $197,000 was in excess of the actual decline in value.

Example 5

Shopping Center

In 1956, Corporation A acquired a shopping center at a cost of about $2,200,000, of which amount slightly under one-half was allocable to depreciable buildings. After claiming a total of about $150,000 for depreciation, a capital gain of $324,000 was realized in 1959 upon sale of the property. The portion of the gain allocable to the depreciable portion of the property, about $140,000, reflected depreciation allowances in excess of the actual decline in economic value of the depreciable improvements.

Example 6

Hotel

In 1955, Corporation A realized a gain of approximately $3,500,000 on the sale of the hotel costing approximately $8,750,000, and with respect to which prior depreciation had been claimed in the sum of about $4,850,000. A substantial portion of the gain of $3,500,000 was allocable to the depreciable real estate and reflected depreciation allowances in excess of actual decline in economic value of the hotel.

Example 7

Hotel

In December 1952, Corporation A acquired a hotel on leased land for $800,500. After claiming depreciation in the amount of $405,500, the hotel was sold in 1959 at a gain of about $172,000. The entire gain of $172,000 reflected depreciation allowances in excess of actual decline in economic value of the hotel.

Example 8

Hotel

In 1953, Corporation A realized a gain of approximately $5,400,000 on the sale of a real estate and hotel thereon costing approximately $22,000,000, and with respect to which prior depreciation had been claimed in the sum of about $12,600,000. A substantial portion of the gain of $5,400,000 was allocable to the hotel and such amount reflected depreciation allowances in excess of actual decline in economic value of the hotel.

Example 9

Apartment and Office Building

In September, 1947, the taxpayer acquired an apartment and office building for $137,000 of which $107,000 was allocated to the building. The estimated useful life of the building was 25 years. After taking depreciation deductions amounting to $44,000 under the straight-line method, the taxpayer sold the property in 1958 for $150,000 of which an estimated $115,000, a sum exceeding its cost, was allocable to the building. The entire $44,000 of depreciation deductions was thus recovered as a part of the capital gain on sale of the property. If an accelerated method of depreciation had been used, the excessive depreciation deductions recovered at capital gains rates would have been considerably greater.

Example 10

Office Building

In 1950, Corporation A acquired an office building at a cost of $5,300,000, of which approximately $1,000,000 was allocated to the land. In 1960, after taking $2,300,000 in depreciation deductions on

the straight-line method, Corporation A sold the property for approximately $6,250,000, of which approximately $1,500,000 was allocable to the land. Of the total gain of approximately $3,000,000, about $500,000 of the capital gain was allocable to the land, which indicates that the entire $2,300,000 depreciation deductions from ordinary income were recovered at capital gain rates. If accelerated depreciation had been used, the income converted to capital gains would have been considerably greater.

Example 11

Commercial Property

In 1948, Corporation A acquired a commercial property for approximately $35,000, of which approximately $28,000 was allocated to the building. Corporation A estimated the useful life of the building as 33-1/3 years, and took deductions for straight-line depreciation which amounted to $9,500 by 1960. In 1960, Corporation A sold the property for approximately $35,000, of which approximately $27,500 was allocable to the building, thus recovering almost the full original cost of the depreciable property. Of the $9,500 capital gain realized from the sale, $9,000 represented excessive depreciation deductions from ordinary income which had been taken under the straight-line method over the 12-year holding period of the property. If an accelerated method of depreciation had been used, the ordinary income thus deferred and converted to capital gain would have been considerably greater.

C. Example of Relationship Between Depreciation and Nontaxable Cash Flow in a Typical Projection

The following table is taken from the prospectus of a typical recent public offering of interests in a new office building. Although the estimated useful life of the building is 33-1/3 years, by the use of accelerated depreciation under the 200 percent declining balance method it is projected that 42.7 percent of the cost of the building will be written off against ordinary income for tax purposes in the first nine years of its useful life, as opposed to 27 percent allowable under the straight-line method.

In the first year, only 4.1 percent of the cash flow to the investor is taxable income; 95.9 percent is tax free cash equivalent to the depreciation deductions taken in that year. The depreciation deductions would decline in subsequent years, and the percentage of cash flow which represents taxable income would reach 93.6 percent in

the ninth year, and 102.9 percent in the tenth year. The entire cash return for the first nine years would include 50.6 percent non-taxable cash flow resulting from depreciation deductions.

The following table shows the return to a purchaser of one $2,600 share in the property. In nine years the investor will have received $2,032 in cash and will also have increased his equity in the property by $1,238 through amortization of the mortgage. Of this total return of $3,270 only $1,004 will have been subject to income tax, while $2,166 will be treated as a return of capital as a result of the depreciation deductions.

The prospectus states that the principal tenant of the building has an option to purchase the land and building after nine years and three months for a price approximately 20 percent above original cost. As the prospectus points out, "the gain upon such sale would be taxed at capital gain rates."

If the projected sale occurs after nine years and three months, as seems to be anticipated by the prospectus, it is clear that the investor will have suffered no actual economic depreciation in his investment. Yet under present law, he would be permitted to pay a capital gains tax on his recapture of the $2,166 of depreciation taken as a deduction from ordinary income in earlier years, as well as upon the remainder of the gain. This is another illustration which clearly indicates that the double-declining balance method overstates depreciation in the early years for typical real estate investment.

TAX TREATMENT OF CASH DISTRIBUTABLE TO EACH HOLDER

Year	(1) Net Distributable Cash	(2) Increase in Equity by Amortization of Mortgage	(3) Total of Net Distributable Cash Plus Increases in Equity	(4) Less Depreciation	(5) Net Taxable Income	(6) Taxable Income As Percentage of Net Distributable Cash
	(dollars)					
1	204.50	108.31	312.81	304.44	8.37	4.1
2	228.50	114.67	343.17	286.17	57.00	24.9
3	228.50	121.41	349.91	269.00	80.91	35.4
4	228.50	128.54	357.04	252.86	104.18	45.6
5	228.50	136.09	364.59	237.69	126.90	55.5
6	228.50	144.09	372.59	223.43	149.16	65.3
7	228.50	152.55	381.05	210.02	171.03	74.8
8	228.50	161.52	390.02	197.02	192.60	84.3
9	228.50	171.01	399.51	185.58	213.93	93.6

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D. ANALYSIS OF REAL ESTATE CORPORATION PROSPECTUSES [a]

	Net Cash Return: Available For Distribution to: Stockholders	Increase in Equity: Through Principal Payments on Indebtedness (dollars)	Net Profit (or Loss) For Income Tax Purposes	Depreciation and Amortization of Buildings and Leaseholds
1. New York Equities, Inc.	468,500	(141,000)	(88,500)	658,000
2. Tenney Corporation	1,579,000	372,000	(17,000)	1,645,000
3. Basic Properties, Inc.	770,746	330,201	(3,870)	1,094,817
4. Kaymarq Consolidated Corporation	278,451	597,526	(131,035)	993,000
5. Kratter Corporation[b]	11,500,000	9,000,000	(1,762,272)[c]	14,049,671
6. Glickman Corporation	4,094,804	924,870	235,950	4,873,353
7. Futterman Corporation	2,443,000	851,000	266,000[d]	2,955,000
8. First Republic Corporation of America	1,368,800	434,100	96,200	1,874,800
9. Real Properties Corporation of America	636,710	337,090	(138,379)	1,100,750
10. Transcontinental Investing Corporation	2,447,400	1,032,600	(1,042,800)	4,522,800
11. H.R. Weissberg Corporation	1,085,393	478,725	(2,413)	1,598,833
Total	26,672,804	14,217,112	936,425	35,366,024

[a] The prospectuses of the respective corporations were dated as follows: 1.-10/31/61; 2.-9/14/60; 3.-9/28/61; 4.-9/1/61; 5.-9/27/61; 6.-8/3/61; 7.-6/8/61; 8.-5/16/61; 9.-10/16/61; 10.-11/13/61; and 11.-1/6/61. The figures were taken from pro-forma annual statements.

[b] Figures are for 27 months actual operation.

[c] Including profit of (approximately) $4 million on sale of a hotel in July 1961, as to which the prospectus states at page 57, Note C: "No federal income taxes are payable for the period of seven months ended July 31, 1961 because of the application of carryover losses of prior years and the use of the installment method of reporting a gain from the sale of a property during the seven month period."

[d] Before net operating loss carryforward and another tax adjustment.

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The above analysis is derived from prospectuses issued in connection with recent public stock offerings by eleven large real estate corporations of the "cash flow" type. Seven of the eleven corporations project losses for income tax purposes. The eleven corporations as a whole will have available $26,672,000 in cash for distribution, yet their income for tax purposes will be only 3.5 percent of that amount, or $936,000. In addition, these corporations will increase their equities in properties by making mortgage amortization payments of $14,217,000. Their $936,000 taxable income will be only 2.2 percent of the $40,890,000 total of their cash available for distribution plus their mortgage amortization payments. The reason why these companies can provide a cash flow which is 96.5 percent tax-free and also make substantial principal payments on mortgages lies in their tremendous depreciation deductions, which will amount to $35,366,000.

E. Projections of Cash Flow and Taxable Income by Noncorporate Real Estate Syndicates Based on Actual Prospectuses

Example 1

Apartment Building

Unit of investment	$5,000
Annual cash flow	550
Percentage - cash flow to investment	11%

Taxable income exceeds cash flow in 8th year.

Year	Cash flow to investor	Amount constituting ordinary income	Amount constituting loss deduction	Percent not reportable as ordinary income
1	$550		$119	100 *
2	550		45	100 **
3	550	$ 60		89
4	550	129		76.5
5	550	162		70.5
7	550	527		4.3
8	550	754		- 37 ***

* Plus loss deduction equal to 21.6 percent of cash flow.
** Plus loss deduction equal to 8.2 percent of cash flow.
*** Minus amounts indicate taxable income in excess of cash distribution.

Example 2

Industrial Park and Buildings

Unit of investment — $5,000
Annual cash flow — Varies from $500 in early years to $773 in 13th full year
Percentage - cash flow to investment — 1st full year 10.0%; 13th full year 15.5%
Taxable income exceeds cash flow after 14th year.

Year	Cash flow to investor	Amount constituting ordinary income	Amount constituting loss deduction	Percent not reportable as ordinary income
1 (6 mos.)	$250		$89	100 *
2	500		123	100 **
3	500		27	100 ***
4	500	$ 62		88 ...
5	506	147		71
10	596	501		16
11	731	559		24
14	773	685		11

* Plus loss deduction equal to 36 percent of cash flow.
** Plus loss deduction equal to 25 percent of cash flow.
*** Plus loss deduction equal to 5 percent of cash flow.

Example 3

Hotel

Unit of investment — $50,000
Annual cash flow — 6,000
Percentage - cash flow to investment — 12%
Taxable income exceeds cash flow in 10th year.

Year	Cash flow to investor	Amount constituting ordinary income	Amount constituting loss deduction	Percent not reportable as ordinary income
1	$5,300	$ 929		82
2	6,000	1,643		73
10	6,000	6,000 +		Taxable income will exceed cash flow

Example 4

Office Building

Unit of investment $5,000
Annual cash flow 500
Percentage - cash flow to investment 10%
Taxable income exceeds cash flow in 15th year.

Year	Cash flow to investor	Amount constituting ordinary income	Amount constituting loss deduction	Percent not reportable as ordinary income
1	$500		$88	100 *
2	500		31	100 **
3	500	$ 25		95
4	500	79		84
5	500	133		73
15	500	500 +		Taxable income will exceed cash flow

* Plus loss deduction equal to 18 percent of cash flow.
** Plus loss deduction equal to 6 percent of cash flow.

Example 5

Motel

Unit of investment $12,000
Annual cash flow 1,200
Percentage - cash flow to investment 10%
Taxable income exceeds cash flow in 12th year.

Year	Cash flow to investor	Amount constituting ordinary income	Amount constituting loss deduction	Percent not reportable as ordinary income
1	$1,200		$1,941	100
2	1,200		1,577	100
3	1,200		1,195	100
4	1,200		858	100
5	1,200		440 *	100
8	1,200	$ 0 +		Less than 100%
12	1,200	1,200 +		Taxable income will exceed cash flow

* Note, at end of 5 years the total of loss deductions and nontaxable income distributions exceeds original investment of $12,000.

Example 6

Apartment Building

Unit of investment $5,000
Annual cash flow 500
Percentage - cash flow to investment 10%
Taxable income exceeds cash flow in 10th year.

Year	Cash flow to investor	Amount constituting ordinary income	Amount constituting loss deduction	Percent not reportable as ordinary income
1	$500	$ 53		89
2	500	112		78
3	500	170		68
4	500	227		55
5	500	284		43
9	500	500		0

Example 7

Apartment Building

Unit of investment $10,000
Annual cash flow 1,200
Percentage - cash flow to investment 12%
Taxable income exceeds cash flow in 14th year.

Year	Cash flow to investor	Amount constituting ordinary income	Amount constituting loss deduction	Percent not reportable as ordinary income
1	$1,200	$ 633		47
2	1,200	666		44
12	1,200	1,189		1

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

Mr. Secretary, I want to ask this question at the beginning: Is it your judgment that American industry is either unwilling or unable to modernize its plant without a special tax incentive?

Secretary DILLON. I think that the record is clear, Mr. Chairman, that American industry will be unable to modernize its industry to the extent and at the rate necessary to help build our economy without a type of tax incentive similar to that which has been used so effectively over the last decade in all the other industrialized countries in the world.

The CHAIRMAN. Why does that condition exist? I thought we had here in America the most progressive businessmen and ample capital. Why haven't we modernized our plants?

Secretary DILLON. Because when you modernize, Mr. Chairman, you take into account the cost, the profitability of the investment, and taking that into account, it is less profitable after taxes to make a new investment in modernization here than it is anywhere else in the industrialized modern world.

The CHAIRMAN. What particular industry has failed to keep abreast of the—you have mentioned the countries in Europe as being ahead of us. Is that due to the fact that many of those factories were built with our foreign aid?

Secretary DILLON. Early and after the war that certainly was correct, Mr. Chairman. There was a big help there. But since then and continuing right through the current year, as tables in the annex show, something like 10 percent of gross national product on the average is devoted to modernization, and improvement of equipment in Europe compared last year to less than about 5 percent in this country. In other words, twice as much.

The CHAIRMAN. It's not correct then, that we excel the rest of the world in mass production?

Secretary DILLON. I think we have an advantage which we have accumulated over the years, but that advantage is rapidly being dissipated and in many lines of equipment, many lines of production, there are factories being built abroad now that are fully equal to and that surpass our factories.

The CHAIRMAN. Do you think it is the lack of funds or the lack of desire, or what is it; why is it they do not modernize?

Secretary DILLON. One of the reasons is, the main reason is, that it is not profitable. Businessmen operate through the profit motive, and we wish to give them the same profit opportunities for modernizing as are presently available to their competitors abroad.

The CHAIRMAN. Well, certainly there are some that have kept abreast?

Secretary DILLON. That is true. There are some industries where profits are so high——

The CHAIRMAN. What industry have you got particularly in mind that is backward; that needs a 7- or 8-percent tax incentive subsidy? I don't want to injure your feelings about this, but I regard this investment credit proposal as a gimmick. Is the steel industry backward in modernizing its plants?

Secretary DILLON. I think our steel industry has to modernize more rapidly than they have because certainly many of the plants in Europe

are now producing steel as effectively and probably cheaper than here because of better equipment.

I think certainly the textile industry needs every help they can have to modernize to meet their foreign competition.

The CHAIRMAN. How about the automobile and the movie industry, are they backward, too?

Secretary DILLON. I think obviously our automobile industry is one of our leading industries because it has had the benefit of a mass market here over a number of years whereas a market is only presently developing in Europe.

The CHAIRMAN. And you don't think our free competitive enterprise—I always like to put that word in there—Do you think the system must change in order to exist?

Secretary DILLON. I believe entirely in the free competitive enterprise system and it is just because of that that I feel our industry ought to have an equal chance to compete with foreign industry which it does not presently have, Mr. Chairman.

The CHAIRMAN. Has the steel industry indicated to you that they desire this special incentive?

Secretary DILLON. Most certainly and aggressively, too.

The CHAIRMAN. Has the automobile industry indicated that?

Secretary DILLON. I don't remember so from them; I haven't talked with them. The steel industry, yes.

The CHAIRMAN. Well now, is it true that the steel industry will get a tax benefit or incentive or whatever you may call it of $100 million in the first calendar year of this operation?

Secretary DILLON. The steel industry? I wouldn't think so.

The CHAIRMAN. You wouldn't think so?

Secretary DILLON. I wouldn't think they will.

The CHAIRMAN. That is the figure I have.

Secretary DILLON. Is that true?

The CHAIRMAN. Consider A.T. & T. They are not lacking in funds or progress, they are one of the leading companies in the world. Is it true that A.T. & T. will get $104 million?

Secretary DILLON. I agree with everything you have to say about the A.T. & T. because we are recommending that the investment credit not apply to the A.T. & T., and they don't want it to apply because they are a regulated public utility and they agree with us it shouldn't apply to regulated public utilities.

The CHAIRMAN. You didn't answer the question, will they get $104 million tax credit?

Secretary DILLON. Under the House bill they could, but we don't think they should.

The CHAIRMAN. Would you veto the bill on account of that? There are a number of other industries in that same position.

Secretary DILLON. We hope the Senate will amend the bill by removing public utilities from this bill.

The CHAIRMAN. I am, I have to confess, very much surprised to see the Secretary of the Treasury come before the Senate Finance Committee and ask for a tax incentive of 8 percent; you still stand for the 8-percent figure, don't you?

Secretary DILLON. That is correct.

The CHAIRMAN. We are supposed to have the most progressive business enterprises in the world and they are so recognized all over the world, I think, otherwise we couldn't have survived. But you think they are not progressive, you think they lack funds or lack the will, or lack something else?

Secretary DILLON. During the last 10 years, Mr. Chairman, the average age of our equipment in our plants has steadily grown older, as again shown in the exhibits, whereas the average age of equipment in the plants of our competitors has steadily grown younger, and many of these plants now are more modernly equipped than ours, and they are providing increasing competition—

The CHAIRMAN. Is this due to lack of money or lack of enterprise or lack of progressiveness on the part of management?

Secretary DILLON. No, it is due to the fact it has not been so profitable here because these incentives were available, tax incentives have been available, to people who operate abroad and not available to this country. Certainly our companies which operate abroad take full advantage of this.

The CHAIRMAN. It is a remarkable indictment of American enterprise.

Secretary DILLON. It is no indictment.

The CHAIRMAN. I always thought we led the world in mass production and certainly our companies have enormous assets running sometimes into billions, yet you think they haven't got the funds on hand to modernize their plants, is that it?

Secretary DILLON. I didn't say they didn't have the funds on hand. I said it was not profitable for them to do it under certain circumstances and with the same speed.

The CHAIRMAN. It will be profitable for them to do it under the competitive enterprise system, will it not?

Secretary DILLON. Not if you don't make a profit.

The CHAIRMAN. In other words, you want to encourage them, to do something which they think would be unprofitable? Eight percent isn't any big amount, and I——

Secretary DILLON. Eight percent is a very big amount. As I said it increases the profitability of investment in a 10-year asset by something like 40 percent, and that is a very dramatic increase.

The CHAIRMAN. Why should they have an incentive more than other businessmen?

There are different kinds of businesses that don't need modernization.

Secretary DILLON. We don't intend in this bill or don't try to differentiate between types of businesses except for regulated public utilities.

The CHAIRMAN. It is a subsidy?

In other words, it is a subsidy to induce them to do something for which they already have the money?

Secretary DILLON. Any type of depreciation, accelerated depreciation, as I pointed out, has an element of subsidy in it, and the investment credit simply is the cheapest method of achieving this.

The CHAIRMAN. You have made it retroactive. I have heard you and all the other Secretaries of the Treasury denounce all retroactive tax bills.

Now, you have a retroactive tax bill here, haven't you?

Secretary DILLON. The reason for this, Mr. Chairman, was that if we had suggested that this should go into effect at some time in the future, it would have meant that all business would have stopped ordering new equipment and waited until the new thing went into effect.

There is also presently very clear indication from the report of the machine tool industry for February that, in view of the uncertainties as to the passage of this legislation, this is already happening, and their orders were substantially down because of this.

This is what they have stated and it is for that reason, not to hold up our economy, that we felt it was necessary to make this provision effective as of the first of the year so business would go ahead investing at its ordinary rate. That is the only reason.

The CHAIRMAN. Well, is this going to be a general plan on the part of the Treasury? You have always opposed every retroactive tax bill, so far as I can remember, and I have been on this committee for many years. You are asking for a retroactive tax relief bill; and what about the man who did his modernization before January 1, is he entitled to any relief?

Secretary DILLON. The credit only applies to investment from this year on out. Now companies have to continually modernize. Any of the other suggestions, and there have been many made, all have the same aspect. They apply to new investment as it is made, and not prior investment.

The CHAIRMAN. This bonus that you are going to give will amount to a huge sum, will it not?

Secretary DILLON. The total cost of the investment credit as we pointed out would be, when fully operative, $1,350 million.

The CHAIRMAN. The staff of the Joint Committee on Internal Revenue Taxation says it will be $1.4 billion.

I don't think this bill will be passed much before July 1. So the bill would be retroactive by 6 months. Has that ever been done before?

Secretary DILLON. I have made very clear the reasons why we felt that we had to take this position so as not to bring all activity, business activity, in the form of investment in new equipment to a standstill in the United States with resulting unemployment and everything that would go with that for 6 months. (Note: When the liberalized depreciation provisions of the 1954 Internal Revenue Code were enacted on August 16, 1954, they applied back to investment after December 31, 1953.)

We felt there was no other course we could possibly pursue. It is obviously up to the Congress to dispose of this and decide when this thing should be effective. But we didn't see how at that time time we could take any other course, and since we have taken that course we have to stand by it.

The CHAIRMAN. Then, of course, a retroactive action like this would not provide incentive to industries that had done their modernization before the bill is passed?

Secretary DILLON. We do think a number of industries may have taken action because they hoped and expected that this law would become law. In that case they——

The CHAIRMAN. Why would they hope and expect that?

Secretary DILLON. Because the administration recommended it.

The CHAIRMAN. There is still a Congress here.

I don't think businessmen take all of the recommendations made by this administration.

Secretary DILLON. Mr. Chairman, it was more than that. The majority of the House Ways and Means Committee had indicated in writing last year that they favored this and were going to report it favorably to the House and I think——

The CHAIRMAN. Did you make any pledges to them in any way that it would be effective back to January 1?

Secretary DILLON. We had simply made this statement. Always in our testimony we felt that this is what it should be and this is our recommendation. We couldn't make any pledges, because the Congress makes the final decision on that.

The CHAIRMAN. I have never known any hardheaded businessmen who took the recommendation of the administration as basis for investing large sums of money, but maybe they do.

I want to ask you a few questions, Mr. Secretary, in regard to the deficits. What is your estimate of the deficit for this fiscal year?

Secretary DILLON. The latest estimate in January was about——

The CHAIRMAN. Before we leave this question of these tax credits. I want to present for the record a statement prepared by Mr. Colin S. Stam, of the Joint Committee on Internal Revenue Taxation, whereby he shows that if there was an increase of 5 percent in the investment, in assets that you covered by the investment credit proposal the loss in 10 years would be $20,990 million. I don't expect you to answer this offhand, but I hope you will give the committee a statement as to whether you think this is accurate. The estimate starts at $1.4 billion in the 1st year and goes to $2,430 million in the 10th year assuming a 5-percent increase in these particular investments.

It is quite a formidable proposition.

(The statement referred to follows:)

APRIL 2, 1962.

Memorandum for Senator Harry F. Byrd, Chairman of the Senate Finance Committee:

The attached table gives, for calendar years 1962–1972, the estimated revenue loss under the investment credit provision of H.R. 10650 as passed by the House of Representatives on March 29, 1962. The estimates in this table were prepared by the staff of the Joint Committee on Internal Revenue Taxation.

ESTIMATED REVENUE LOSS UNDER INVESTMENT CREDIT PROVISION OF H.R. 10650 AS AMENDED BY WAYS AND MEANS COMMITTEE FLOOR AMENDMENT, 1962-72, ASSUMING AN ANNUAL INCREASE OF 5 PERCENT IN INVESTMENT IN ELIGIBLE ASSETS [1]

Revenue loss attributable to investment credit on assets acquired or constructed in calendar year

[In millions]

On current revenue loss basis [2]		Including deferred revenue loss [3]	
Calendar year	Revenue loss	Calendar year	Revenue loss
1962	$1,400	1962	$1,400
1963	1,470	1963	1,500
1964	1,540	1964	1,610
1965	1,620	1965	1,730
1966	1,700	1966	1,810
1967	1,780	1967	1,900
1968	1,870	1968	2,000
1969	1,960	1969	2,100
1970	2,060	1970	2,200
1971	2,160	1971	2,310
1972	2,270	1972	2,430
1962-66	7,730	1962-66	8,050
1962-72	19,830	1962-72	20,990

[1] This is the level of increase assumed by the Secretary of the Treasury in address on Mar. 19, 1962.
[2] Without allowance for fact that some of the revenue savings arising out of the $25,000 limitation will be lost in subsequent years through operation of the carryforward provision.
[3] With allowance for the assumption that 50 percent of the revenue savings arising out of the $25,000 limitation will be lost in subsequent years through operation of the carryforward provision.

What is your estimate, Mr. Secretary, as to the deficit for this fiscal year?

Secretary DILLON. As I said, Mr. Chairman, the latest estimate was, I think, $7 billion.

The CHAIRMAN. $7 billion. When you are going to reestimate that?

Secretary DILLON. On June 30, I should think.

The CHAIRMAN. June 30—you will have the actual deficit at that time.

You made quite a few estimates on the budget last year, as I recall it. I was called to see the President in January 1961 and he said that he was told by you that the deficit last year would be a billion, five hundred million.

I said, "I hope that you will check on that," so he called you on the phone. I don't know whether he got you but he got the Director of the Bureau of the Budget and they confirmed that.

Now, the deficit just a few months later was actually approximately $4 billion as you know, that is for the last fiscal year.

The budget document for fiscal year 1961—submitted in January 1960—estimated a surplus of $4.2 billion.

This was followed by four downward revisions in two official statements by the past administration, and two by the present administristration.

In the last of these revisions the Secretary of the Treasury, at the National Press Club last June 20, said the 1961 deficit would "approach $3 billion."

Ten days later, when the fiscal year ended, the actual deficit for fiscal year 1961 turned out to be $3.9 billion.

For fiscal year 1961 there was deterioration of $8.1 billion between the first estimate of a $4.2 billion surplus and the actual deficit of $3.9 billion.

Now consider fiscal year 1962—the current year which ends in 3 months, on June 30.

The original budget document, submitted in January 1961, estimated another surplus—this time a surplus of $1.5 billion.

Since then six major revisions can be documented—all downward. The latest estimate for this year was published in the President's budget document of January 18, 1962, which estimated a deficit of $7 billion.

To date there has been deterioration of $8.5 billion in estimates for fiscal year 1962—from an original estimate of a $1.5 billion surplus to the latest prediction of a $7 billion deficit.

There have also been some estimates for fiscal year 1963 which begins next July 1.

Last June 20, at the National Press Club, the Secretary of the Treasury said the administration anticipated revenues in fiscal year 1963 "adequate to meet all our needs with something left over."

Since then there have been 11 other statements by Federal officials making approximately the same estimate.

The President, in his 1963 budget document of January 18, 1962, said "the administrative budget for 1963 shows a modest surplus of about $500 million."

I don't claim any more ability to predict deficits than anybody else; but with some credit to myself, I must say that the joint committee which I head has been more accurate in its estimates throughout the years than officials of the various administrations.

Instead of the present official estimate of a $7 billion deficit in the current fiscal year, ending June 30, I predict a deficit of between $8 billion and $9 billion.

If you add to that today's estimate by the staff of the Joint Committee on Internal Revenue Taxation that the deficit next year will be $4 billion or more, you will have a combined deficit of $13 billion in 2 years, and up to $17 billion in 3 years.

You know what happened to us in 1958–59 when the Eisenhower administration had combined deficits of $15 billion. How important do you think it is to balance the budget?

I submit for the record an estimate of the Federal deficit for fiscal year 1963 prepared today by the Joint Committee on Internal Revenue Taxation.

(The material referred to follows:)

ESTIMATE OF DEFICIT FOR FISCAL 1963 PREPARED BY JOINT COMMITTEE ON INTERNAL REVENUE TAXATION ON APRIL 2, 1962

APRIL 2, 1962.

Hon. HARRY F. BYRD,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BYRD: In accordance with your request, we have made an estimate of the receipts for the fiscal year ending June 30, 1963. This estimate assumes the expenditures in the budget for 1963. It does not take into account expenditures not included in the 1963 budget which, of course, may increase the deficit. We have given two estimates for the fiscal year 1963—one not taking

into account the pending tax bill and the other giving effect to the pending tax bill.

Sincerely yours,

COLIN F. STAM, *Chief of Staff.*

Receipts, expenditures, and deficit of the Federal Government, fiscal year 1963

	Millions
A. Staff estimate of budget receipts (assuming extension of present rates of corporate and excise taxes, but excluding revenue effect of pending tax bill, H.R. 10650)	$88,719
Budget expenditures (as shown in budget for fiscal year 1962)	92,537
Deficit (excluding revenue effect of H.R. 10650)	3,818
B. Staff estimate of receipts (including revenue effect of H.R. 10650)	87,629
Budget expenditures (as shown in budget for fiscal year 1963)	92,537
Deficit	4,908

Personal income and corporate profits

[In billions]

	Calendar year 1961 (Department of Commerce)	Calendar year 1962 estimates underlying fiscal year 1963 budget receipts	
		Treasury estimates	Staff estimates
Personal income	$416.7	$448.0	$443
Corporate profits	46.1	56.5	53

Secretary DILLON. I think that it is most important to balance the budget in a time of reasonable prosperity, and over a business cycle. I don't think that you can achieve full balance in years when you have depression revenues which is the case this year.

It looks like our revenues from our corporate taxes will actually be smaller this year, this fiscal year, than they were in the last fiscal year.

The CHAIRMAN. That cycle theory is thoroughly discredited by the facts you well know. How many balanced budgets have we had in the last 25 years?

Secretary DILLON. I think very few.

Do you have any reason to think that the future holds forth hope for a balanced budget? You are here advocating a proposal that is going to take over $1 billion out of the revenue. If this bill is passed, do you believe the budget is going to be balanced the next fiscal year?

Secretary DILLON. We certainly hope so. But as regards this bill, Mr. Chairman, in this area I could only say that we have to agree here, and we do agree, with the position that was taken by one of my predecessors, Secretary Humphrey, in 1954 when a large tax reduction in the form of depreciation changes was made. And before this very committee, they stated that they felt that this reduction would so stimulate business that business would move faster, and overall the Government would get more money. And events, I think, proved them right.

I think events will prove the same thing here, that this will stimulate business to such an extent that we will not——

The CHAIRMAN. It did not prove him right in 1959 when we had a deficit of $12.4 billion, the largest peacetime deficit of all time.

Secretary DILLON. That certainly was not attributable to the fact that they changed the depreciation laws in 1954.

The CHAIRMAN. There is obviously no firm determination on your part of trying to get a balanced budget by cutting expenditures. That is the only way to get it.

Secretary DILLON. We are recommending an increase in taxes here of $965 million a year.

The CHAIRMAN. A report by Mr. Colin Stam, Staff Director of the Joint Committee on Internal Revenue, available to the Finance Committee today, does not show any net increase in revenues.

Secretary DILLON. I am not sure that Mr. Stam has, in fact I am sure that he has not had a chance to evaluate as yet our recommendations which I just made before the committee.

The CHAIRMAN. I am speaking of the House bill that is before us now.

Secretary DILLON. Oh, yes. The House bill shows only a very small balance.

The CHAIRMAN. How much of a deficit have you got in the House bill?

Secretary DILLON. As we show it, the House bill shows a surplus of $120 million, and Mr. Stam's figures show that there is a deficit of some hundreds of millions of dollars. I do not know what his figures are. But the changes we have recommended would add some $845 million of revenue to the House bill and would produce a surplus of $965 million by our estimates, and would certainly produce a surplus by any estimate Mr. Stam would make, too, although it might be a somewhat smaller one.

The CHAIRMAN. Mr. Stam figures that the House bill would bring about a shortage there of $1,090 million, which is pretty far apart. Your estimate is $800 million on the House bill.

Secretary DILLON. We are adding, we recommend adding, $800 million-plus, $845 million, to the House bill.

The CHAIRMAN. As I say, you yourself estimate a $800 million loss on this bill, do you not?

Secretary DILLON. I do not quite understand, because our estimate of the effect of the House bill, when fully operative, is a surplus of $120 million.

The CHAIRMAN. When fully operative. But in fiscal 1963 Mr. Stam has furnished me a report showing the estimate of loss to be $1.445 billion, and there is a gain of $625 million by reason of the amendment adopted by the House which, as I understand, you want to strike out.

Secretary DILLON. I think there is——

The CHAIRMAN. I believe we have taken the Treasury's own figures there, and that leaves a shortage in the next fiscal year on this particular legislation of $800 million.

Secretary DILLON. I am aware now of what you are referring to. These were the figures without giving any consideration at all to the effects of any of this legislation on the economy during this year. As I pointed out, when you make a change in midstream like this we have to reconcile it with the budget and take into account the effects that there will be on the economy. On that basis our table 4 shows that we feel there would be a deficit of $320 million in the bill without giving effect to the basic stimulative effect or the full stimulative effects of the credit.

With our changes we expect there will be a $90 million surplus. Mr. Stam's estimate does not consider the effect on the economy at all. Our estimate was for a gross loss of revenue of $835 million in the bill, as it passed the House, and with the changes we suggested here that would be reduced by about $500 million to $345 million in the next fiscal year. Certainly it is unrealistic not to take account of the effect of these major actions on the economy and, in so doing, we think that the bill as we have recommended it here today, will not have any adverse effects on the budget for 1963.

The CHAIRMAN. Do you agree with Mr. Stam that the loss from the investment proposal will be $1.4 billion the first year, and $2.4 billion in the 10th year?

Secretary DILLON. I think our figures for 10 years probably would not be far different from Mr. Stam's, but we do not think there would be any loss, because we think, as a result of this bill, there will be a great deal more business, a great deal more people employed, a great deal more activity, which will all bring in additional taxes which you would not get otherwise, and that, therefore, this would pretty well offset itself.

As I point out, this is exactly the same position as has always been taken by the Treasury in the past on this type of legislation.

The CHAIRMAN. If you overstimulate or influence any industry to produce more than they can sell, what will be the effect of that?

Secretary DILLON. I do not think industry will overstimulate itself to produce more than it can sell. We have got to let industry make these decisions themselves in a competitive system.

All we are asking is to give them the same opportunities that their competitors have abroad, and which would put them on a basis of equality with the rest of the world.

The CHAIRMAN. You do not think then that under the present tax system and these industries with enormous resources can do it if they desire? They have not got the finances to do it?

Secretary DILLON. There is not the profitability there. They simply are not on a basis of equality with an investment on which, if made in any one of the countries of Europe, they would get a far better and far more profitable deal in the way of depreciation.

The CHAIRMAN. Some few of these companies have been progressive, have they not?

Secretary DILLON. What is that, Mr. Chairman?

The CHAIRMAN. Some few of these have been progressive.

Secretary DILLON. Of course. I am talking about the economy as a whole.

The CHAIRMAN. What about those who spent this money before January 1 last?

Secretary DILLON. I am talking about the economy as a whole, which is the only way we can look at it.

The CHAIRMAN. Take the steel companies; the steel industry is reported to be operating at 79 percent, is that correct?

Secretary DILLON. I think they are about 80 percent; yes, sir.

The CHAIRMAN. If you increased the production of steel, where will you sell it?

Secretary DILLON. This does not necessarily increase the production. It just means that they have a profitable incentive to modernize

their steel facilities so they can produce steel at a cheaper price and do not have to increase the price of steel. That would probably be the most important fact.

The CHAIRMAN. Aluminum is about 78 percent of capacity, is it not? The capacity to produce aluminum is about 78 percent; tools, and so forth.

I am frank to say, Mr. Secretary—and I have great respect for you and personal affection, I have known you for many years—to me this is an amazing proposition in the way you present it. Namely, this country is backward, in the way you present it; the industries are not willing to use the money they have on hand, to save money for themselves; they have to have a tax incentive, which I say to you is a subsidy, just as the farmers who get a subsidy not to plant. And now you are giving a subsidy to industries to produce more or produce efficiently. In other words, the Government enters into a field that they should not go into. What are you doing to the competitive enterprise system we have in this country?

More and more, the Government is trying to interfere with it. Government is trying to dictate to industry. If industry is made to depend on such a subsidy as this, and if 8 percent is not enough, later on it will ask for 10 percent or 12 percent or 15 percent, and you have opened up a new avenue of spending in a sense that you reduce the taxation to that extent; is that right?

Secretary DILLON. The main thing here is that we feel just as strongly as you do, Mr. Chairman, that competitive American industry is the keystone of our success. We feel we have got to keep it that way. And the rest of the world——

The CHAIRMAN. Excuse me a minute, who is "we"? Do you mean the U.S. Government?

Secretary DILLON. The Treasury.

The CHAIRMAN. Or the people of this country, the manufacturers, the business people?

Secretary DILLON. I believe they feel about this way, too. I am talking about "we" in the Treasury. We do feel, though, we have to give our industry equality before the tax law with their competitors in the rest of the world. We are moving into a world where we are in much closer competition. The competition is becoming much stronger. We are talking about reducing our tariffs which will make the competition even greater. We just cannot live in that world if we do not give our industry the same rules that the rest of the world has.

The CHAIRMAN. Have other countries done this by government subsidy?

Secretary DILLON. What?

The CHAIRMAN. Have the other countries done it by government subsidy?

Secretary DILLON. If you call it a government subsidy. Every single one of these other governments, by one special means or another, give incentive depreciation allowances over and above the reasonable lives of machinery and equipment, which this investment credit would just offset. So they give them about the same.

The CHAIRMAN. Do they extend tax credit such as you propose, in addition to depreciation?

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Secretary DILLON. They have investment allowances over and above depreciation, the same thing as tax credits, in the United Kingdom, in the Netherlands, in Belgium, and they are presently just in the process of enacting one in Australia. So there are four countries that have the identical type of law we are talking about.

The CHAIRMAN. Isn't it possible that a good part of that they are able to do because of the fact that we have given them $100 billion in foreign aid all around the world and have rebuilt the factories with the most modern machinery that could be obtained? I know that is true with Japan because I have just come from there. You have got to look at that end of it.

I do not say that all of the $100 billion was used in that fashion, but I think a good deal of it was. Yet we are continuing the foreign aid. If we must give a tax incentive to our people here in order to get them to be efficient, it is certainly news to me.

I thought that we had a pretty efficient business organization in this country. I am very much surprised to hear you say that we are so far below the rest of the world in efficiency.

Secretary DILLON. I did not say that, Mr. Chairman.

The CHAIRMAN. What did you say?

Secretary DILLON. I merely said we were not investing at the rate that the rest of the world was, and so our relative situation was worsening, and that is true.

We started so far ahead of the others that we are still ahead, I am sure. I am sure in many industries that are very profitable we still have the most modern plants in the world. But there are others where it is a well-known fact, such as the textile industry which is an example—and it is a great industry—that we have had great difficulty in keeping up. The credit is designed to help this situation, and it is strongly supported by all the members of the textile industry. The Cotton Manufacturers Association has come out strongly in favor of this, as have the textile machinery people. They feel it is necessary if they are going to continue to compete against the imports that are being produced with more modern machinery abroad.

The CHAIRMAN. You do not think that is a matter for the individual consideration of a company? You do not think that your plan will create any differences between different manufacturers? Some have already done this modernization, and if they have already done it they certainly do not want to do it again, and they will not get the 8 percent.

Secretary DILLON. Modernization is a continuing process, Mr. Chairman, and there is no way of giving this for past effort without having a cost to the Federal Government that would be so high that it would be infeasible.

The CHAIRMAN. As I see it, you are simply creating another dependence upon the Federal Treasury for manufacturing plants to do what they should do themselves and for which they have the money. I do not know the total cost of the assets of these companies, maybe you do, but it runs into billions of dollars, and the rich companies will have the same reduction in this incentive plan as the poorer ones, will they not?

Secretary DILLON. I can give an example of what I mean in the case of a very strong industry where this would probably have a decisive effect. I think maybe it is easier to consider this in the case of an example. Take the steel industry.

We have a need in the steel industry to have iron ore, and there have to be additional sources. The steel industry is faced with a consideration of whether they will put new taconite mining facilities in the depressed area of northern Minnesota or whether they will go abroad to Labrador and put more facilities there to get the higher grade ores that come from there.

A very essential element in their decision, in fact the only element in their decision, is going to be the costs. And if they can have this type of credit, the chances are very strong that that investment will go into a depressed area, will help American industry, and will not go to Canada; that is the case of a very wealthy industry. So it is not a question of whether they have the money or not. It is a question of where they are going to spend the money.

The CHAIRMAN. Suppose a company is up in Labrador. Do they get a tax credit up there?

Secretary DILLON. They do not.

The CHAIRMAN. In other words, if an American company has a branch in Labrador?

Secretary DILLON. It is just limited to the United States.

The CHAIRMAN. Well, Mr. Secretary, I am awfully sorry I cannot agree with you on this, and I want to make it clear that my opposition is not based entirely on the costs. It is based on the fact that we are subsidizing private industry to do the things it should do for itself in a competitive field. If it does not modernize and it is going downhill, and that is the incentive that keeps this great private enterprise system of ours going. Is the government going to come in here and say, "Now, we offer you a big inducement to modernize despite the fact that you have the money to do it yourself." You do not deny that?

Secretary DILLON. Some of them have, some of them do not have. Many smaller——

The CHAIRMAN. Mention some industry that does not have considerable funds on hand.

Secretary DILLON. I can think of very many small businesses among the hundreds of thousands of small businesses all over this country that do not have the money to buy the equipment they would like to buy.

The CHAIRMAN. A lot of small businesses are not going to get much benefit out of this.

Secretary DILLON. They are going to get a great deal of benefit out of this. It is supported very strongly by the National Small Businessmen's Association which feels it is very favorable to small business.

The CHAIRMAN. What other associations have endorsed this bill?

Secretary DILLON. The American Railroad Association, Edison Electric Institute, the National Coal Association, the machine tool people, the electronic products industry. These are just a few of those who support the credit.

The CHAIRMAN. The U.S. Chamber of Commerce endorsed it?

Secretary DILLON. The U.S. Chamber of Commerce last year opposed the investment credit as we recommended putting it into effect. I do not know what their position is this year. When their tax policy committee met in Washington recently I think they took no position on it one way or the other.

The CHAIRMAN. What about the National Association of Manufacturers?

Secretary DILLON. As I mentioned, the National Association of Manufacturers as an association is opposed to it, continues to be opposed to it, and prefers to have the incentive with a subsidy in another manner through higher depreciation.

The CHAIRMAN. Couldn't you approach the situation by giving them relief through depreciation; so that when they go through the base and use it up there is no further deduction from taxes.

Secretary DILLON. But your accelerated depreciation is just as much of a subsidy because the Government never gets the acceleration back unless a company goes out of business. It continues along on a level basis. It keeps a certain amount of subsidy. If it continues to grow, that subsidy grows as it grows, and I would be very glad to show just how that works. We have made a table here because it is most easily shown in a table, which, I think, might go into the record here if you would permit it. It shows how under our present 200 percent declining balance depreciation and under triple declining balance depreciation, as compared with straight line, this is a gift or a subsidy, or whatever we want to call it, that does not come back to the companies who take advantage of it. And double declining balance depreciation is in our law at present; so what we are doing is nothing much different. I would like to ask that it be passed around.

(The table referred to follows:)

Comparison of straight line, 200 percent declining balance, and 300 percent declining balance depreciation methods, annual purchase on each Jan. 1 of a 5-year asset, no salvage value

CONSTANT AMOUNT PURCHASED EACH YEAR

Beginning of year	Annual purchase	Straight-line depreciation charge each year	200 percent declining balance depreciation charge each year [1]	Excess depreciation charge each year*	Cumulative excess depreciation charge	300 percent declining balance depreciation charge each year	Excess depreciation charge each year*	Cumulative excess depreciation charge
1	1,000	200	400	200	200	600	400	400
2	1,000	400	640	240	440	840	440	840
3	1,000	600	784	184	624	936	336	1,176
4	1,000	800	892	92	716	974	174	1,350
5	1,000	1,000	1,000	0	716	1,000	0	1,350
6	1,000	1,000	1,000	0	716	1,000	0	1,350
7	1,000	1,000	1,000	0	716	1,000	0	1,350
8	1,000	1,000	1,000	0	716	1,000	0	1,350
9	1,000	1,000	1,000	0	716	1,000	0	1,350
10	1,000	1,000	1,000	0	716	1,000	0	1,350

GROWING AMOUNT PURCHASED EACH YEAR [2]

Beginning of year	Annual purchase	Straight-line depreciation charge each year	200 percent declining balance depreciation charge each year [1]	Excess depreciation charge each year*	Cumulative excess depreciation charge	300 percent declining balance depreciation charge each year	Excess depreciation charge each year*	Cumulative excess depreciation charge
1	1,000	200	400	200	200	600	400	400
2	1,100	420	680	260	460	900	480	880
3	1,210	662	892	230	690	1,086	424	1,304
4	1,331	928	1,088	160	850	1,233	305	1,609
5	1,464	1,221	1,306	85	935	1,381	160	1,769
6	1,610	1,343	1,437	94	1,029	1,520	177	1,946
7	1,771	1,477	1,580	103	1,132	1,672	195	2,141
8	1,948	1,625	1,738	113	1,245	1,840	215	2,356
9	2,143	1,788	1,912	124	1,369	2,028	235	2,591
10	2,357	1,966	2,103	137	1,506	2,224	258	2,850

[1] With switch to straight line after 3d year.
[2] Growth of 10 percent per year.
*Excess over straight line.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Apr. 4, 1962.

The CHAIRMAN. I am trying to say that although I am chairman of this committee, I have had no demands made upon me from businessmen—I think the railroads and others might want it—but in general businessmen have been very silent about it. I get a big mail about matters that come before the committee, and I am surprised to know that there is such a big demand for it.

I assume you have for the record, the position of the different organizations, on the investment credit proposal?

Secretary DILLON. Oh, yes, we have a record of those.

(The material referred to follows:)

The goals of the investment credit are universally favored by business groups. The credit itself, as a method of achieving these goals, is now favored by many organizations, including the following:

American Cotton Manufacturers Institute.
American Hotel Association.
American Textile Machinery Association.
American Trucking Associations, Inc.
Association of American Railroads.
Edison Electric Institute.
Electronic Industries Association.
Machinery and Allied Products Institute.
Machinery Dealers National Association.
National Lime Association.
National Small Business Association.
National Coal Association.

The CHAIRMAN. Now, Mr. Secretary, I am going to ask you about one more situation. Do you think there is any connection between a deficit and the seeping away of our gold? I understand your imbalance of payments is improving, but you are still losing the gold.

Secretary DILLON. Well, the reason for that loss in this particular quarter, Mr. Chairman, is that the dollar holdings abroad have been shifting from countries which hold dollars traditionally to countries which make a practice of holding all their reserves in gold, particularly the United Kingdom. In other words, funds have been flowing from the continent of Europe to the United Kingdom, and when they get there the United Kingdom transfers them into gold, and the place they get gold is from us.

So that is the reason largely for the substantial gold outflow in this first quarter that was so——

The CHAIRMAN. We have the lowest gold supply for how many years?

Secretary DILLON. We have the lowest gold supply for some 22, 23 years. During the war——

The CHAIRMAN. You remember when I met you over in Geneva?

Secretary DILLON. Yes, I do.

The CHAIRMAN. That was shortly after that big drain on gold began in 1958, I think, was it not?

Secretary DILLON. I think it was a little later than that. It was probably in the summer of 1960, maybe, or 1959.

The CHAIRMAN. Well, I asked the Ambassador there if he would arrange a meeting for me with Swiss bankers so that I could ask them why it was that they called for the gold in large quantities, beginning in the year 1958. They told me that they themselves did not do it. I talked to you at the time.

They said they did not do it, but we had a deficit here of more than $12 billion which they could not comprehend, they could not comprehend why we had such a deficit. There was no great depression, they thought we were entering into a heavy inflation, and they started to take gold, as you know, and it has not stopped yet, has it? How much free gold have we got left?

Secretary DILLON. We have $16,600 million.

The CHAIRMAN. Free?

Secretary DILLON. Free? $5 billion.

The CHAIRMAN. Suppose that goes and we cannot give gold in our settlements that we make abroad, we cannot give to those central banks the choice of gold or dollars. What will happen?

Secretary DILLON. We still give them their choice.

The CHAIRMAN. I did not ask that. I said suppose when the time comes that our free gold is gone, what will happen when we make the settlements and some foreign nation demands gold and we have not got the gold?

Secretary DILLON. If we have not got the gold and do not give them the gold, we would then be off the gold standard and our dollar would depreciate in value.

The CHAIRMAN. That would be a great catastrophe, would it not?

Secretary DILLON. It certainly would. I cannot imagine a greater one.

The CHAIRMAN. I believe these constant deficits have some bearing on it. It certainly was in 1958–59. That is a reason I am anxious that it not be continued. You say there is some prospect of having a balanced budget, and I want to make a prediction, and I hope I am not right, in these 2 years, this year and the next fiscal year, we are going to have a deficit almost as great as we had in 1958–59. In other words, it is going to be $13 billion in 2 years. If you want to bet a hat on it I will bet you you a hat. [Laughter.]

Secretary DILLON. Since last year's results must depend on the course of economic recovery over the rest of the year, I am only betting on this year's results.

The CHAIRMAN. I want an Alpine hat, by the way.

Senator KERR. Alpaca?

The CHAIRMAN. Alpine, a Swiss hat. I am confident of winning. I hope I do not. I hope I am wrong.

Senator KERR. That is no relation to Vicuna? [Laughter.]

The CHAIRMAN. Senator Kerr?

Senator KERR. Did the Chairman put the tables submitted by the Secretary into the record?

The CHAIRMAN. Yes.

Senator KERR. I do not want to ask very many questions. I want to make an observation or two, and only ask three or four questions.

I personally think that the industrial environment which now exists in many highly industrialized countries, and in our own, has resulted primarily from certain policies of this Government which have been made possible by the action of the Congress upon the recommendations of this committtee which, for many years, I opposed.

Not all of them resulted from actions of Congress recommended by this committee, but I think a majority of them were actions taken by the Congress upon the recommendations of this committee.

I think the efficiency of the foreign industrial communities has resulted from a number of causes, including our foreign aid, investment by American companies in modern industrial facilities abroad, the incentive for which, of course, has included lower labor costs abroad, but those alone would not have brought about the result that now exists.

The tremendous investments of American capital in modern industrial facilities abroad would not have occurred had it not been for the lowering of tariffs under the extensions of the Reciprocal Trade Agreements, which the Congress has provided upon the recommendation of this committee, and the increased imports from those highly industrialized and modern facilities abroad producing competing products with those of industries in this country, to the detriment of the products produced in this country.

Preceding Presidents have negotiated these agreements under the authority granted through these extensions of the reciprocal trade agreements program, and a very great deal of the modern industrial productive facilities now operating abroad, producing products not only for the world market but for this market, have come about primarily because of the availability of the American market for products of those industrial developments abroad.

That, however, is a reality, not a theory, and I think that the present approach of this committee and of the Congress should be on the basis of conditions as they exist and not as they would be had it not been for the mistakes made by the Congress upon the recommendation of this committee in the past.

We talk about competition, Mr. Secretary, and in the world in which we now live and compete we have competition in more than one area and of more than one kind. Domestic industries compete with each other for the domestic market. They also have to compete with the industrialized facilities of other countries with access to this market; is that correct?

Secretary DILLON. That is correct; yes, Senator.

Senator KERR. Now, as I understand the situation, not only from the basis of your testimony but also from any accurate analysis of it, there are many areas of production opportunities today in which it is still more profitable for an American industry to build productive facilities abroad than for them to build those productive facilities at home; is that correct?

Secretary DILLON. Very much so; yes.

Senator KERR. And a continuation of that advantageous situation for American industries to expand their foreign productive facilities merely accentuates the adverse position in which domestic production facilities now find themselves in their effort to compete, either with productive facilities owned abroad but with access to world markets and this market, or with their own productive facilities abroad now or about to be built and with productive facilities built abroad by other Americans or other foreigners in the favorable environment that exists in these other highly industrialized countries as compared to the situation that exists here with reference to the incentive to improve and modernize our productive facilities.

Is that an accurate statement, Mr. Secretary?

Secretary DILLON. I think it is entirely accurate; yes, sir.

Senator KERR. Under present laws is there any other highly industrialized country which provides greater incentive for additional productive capacity, or for modernizing existing industrial capacity, than the provision in this bill for modernizing present American industrial capacity?

Secretary DILLON. This bill would put the United States about in the middle compared with countries of Europe.

Senator KERR. I am not talking about what this bill would do. I am talking about without this bill.

Secretary DILLON. Without this bill, every single one of the other industrialized countries in the world provide substantially greater incentives to modernization.

Senator KERR. Not only to production facilities owned in those countries by their own nationals or nationals of other countries than our own, but also to American industrial enterprises?

Secretary DILLON. That is exactly so, and that is why one of the effects of the investment credit would be to give investment opportunities for our own industries in this country comparable to what they now have abroad.

Senator KERR. As I said a moment ago, I think that condition prevails, whether right or wrong, by reason of conditions that have been largley contributed to by actions of this Congress on the recommendations of this committee.

Therefore, it would seem to me that even though it is late for this committee to move to rectify a condition which it itself has helped to create, it certainly is a matter with reference to which the most enlightened and favorable consideration should be given.

Secretary DILLON. I hope it will be.

Senator KERR. Now, in view of the fact that present laws in every other highly industrialized country in the world with whom we have trade agreements and trade arrangements, and who have access to this market, provide greater incentives for more efficient industrial machinery, the building of which would provide further competition with American industry, both in the world markets and in our own market, how much of that advantage, Mr. Secretary, would be eliminated by this bill?

Secretary DILLON. Well, this bill, Senator, in combination with administrative revisions which we are able to make under the law in our administrative guidelines for depreciation——

Senator KERR. That is with reference to depreciation?

Secretary DILLON. That is right. The combination of the two would, we think, put American industry in a position of rough comparability to European industry.

There would still be countries in Europe where the situation was more favorable, but there would be some countries in Europe where it would be less favorable, and I think we would be right about in the average.

In reaching this position, I would say about something over three-quarters of that result would be achieved through this bill, and something less than a quarter could be achieved through modernization of depreciation allowances.

Senator KERR. That is the regulatory approach you are talking about.

Secretary DILLON. That is right.

Senator KERR. There is not any way for this Congress, under our American way of life, nor would it if it could, pass legislation that would give American industrial units an equal labor cost with those that produce in foreign industrialized countries, is there?

Secretary DILLON. No; it is impossible and undesirable.

Senator KERR. We could not if we would, and we would not if we could.

Secretary DILLON. Right.

Senator KERR. So in contemplation of this and in a coldblooded analysis of the competitive features insofar as the position of American industry contrasted to industry in foreign countries is concerned, if we are going to provide anything like equal opportunity for American industry to compete, we have to do it in areas other than in the area of equalizing the labor costs?

Secretary DILLON. That is correct.

Senator KERR. It is the judgment of the Treasury Department that the recommendations you bring to us would help to the extent of putting American industry, generally speaking, on an average competitivewise with industrial capacity in other countries?

Secretary DILLON. That is correct.

Senator KERR. Part of the drain of our gold, a part of the unfavorable balance of payments of our gold situation or a part of our deficit in the balance of payments, has been caused by the investment of American dollars in foreign industrial capacities, has it not?

Secretary DILLON. That is right.

Senator KERR. Can you tell this committee the average amount of annual investment by American industries in foreign industrial productive facilities for the past 12 years?

Secretary DILLON. Capital outflow to all developed countries, which include Canada, Western Europe, Japan, South Africa, Australia, and New Zealand, was in the neighborhood of $500 million a year or a little less up to the year 1956.

Senator KERR. Now, beginning when?

Secretary DILLON. 1953, 1954, and 1955.

Senator KERR. That is about $1.5 billion in 1953, 1954, and 1955?

Secretary DILLON. That is right. In 1956 and 1957 it was over $1 billion in each of the years.

Senator KERR. Now, in 1956 and 1957 it was a total of how much?

Secretary DILLON. $2.16 billion.

Senator KERR. $2.16 billion.

Secretary DILLON. It was about $700 million in 1958.

Senator KERR. $700 million in 1958.

Secretary DILLON. And 1959 it went back to $1.06 billion.

Senator KERR. In 1959, $1.06 billion.

Secretary DILLON. In 1960, $1.486 billion.

Senator KERR. In 1961, do you have an estimate?

Secretary DILLON. 1961, it would be approximately the same as 1960.

Senator KERR. A billion——

Secretary DILLON. Pretty close to a billion and a half dollars.

Senator KERR. $1½ billion.

Then, beginning in 1958 and proceeding through 1961 the total outflow of dollars for capital investments abroad, primarily in productive facilities, manufacturing or extractive facilities, equals about $8½ billion?

Secretary DILLON. I think that these figures also include portfolio investment, which is investment in stocks and bonds in these different countries, in addition to direct investments in plants. But that is much the smaller part of it.

Senator KERR. You mean the investment in productive plants is much the larger percent of it?

Secretary DILLON. That is correct.

Senator KERR. In other words, had it not been for that outflow of dollars for investment in foreign productive facilities, we would have as much free gold today as we had 8 or 10 years ago?

Secretary DILLON. Well, I do not know whether it would work exactly that way, but——

Senator KERR. Well, limiting——

Secretary DILLON. We would have a lot more than we would have now.

Senator KERR. Limiting the calculation to that item.

Secretary DILLON. Yes; we would have a lot more than we have now.

Senator KERR. In the opinion of the Treasury, if competitive incentives are provided for the building of modernizing facilities in the United States and for the modernization of existing facilities in the United States, it will favorably affect the balance of payments in gold in at least two ways: Number one, it would decrease or reduce the amount of American dollars that would be spent in what are now more favorable environments in other highly industrialized countries.

Secretary DILLON. That is correct.

Senator KERR. Number two, it would give us more efficient productive facilities here that would enable us to better compete in the world market, which would result in an increase comparably speaking in our exports which, within itself, would also improve our position in the matter of our balance of gold payments.

Secretary DILLON. Yes. And in talking about this export increase, I am sure that you have in mind that increasing our competitiveness also increases our competitiveness against imports into this country.

Senator KERR. I said by the modernization of our own plants we would be able to produce more efficiently.

Secretary DILLON. That is right.

Senator KERR. And thereby compete more efficiently not only for the world market whereby we would sell and receive dollars, but also we would compete more efficiently for the domestic market and, thereby, reduce the imports that come in here.

Secretary DILLON. That is what I had in mind.

Senator KERR. In both ways, improve our balance of gold payments position.

Secretary DILLON. That is exactly correct, and this is why we feel this investment credit is one of the important elements in our efforts to right the balance-of-payments deficits which we have had for so many years.

Senator KERR. With reference to corporations or individuals or companies having the money to build productive facilities, would this not indicate they had the intelligence to make the money?

Secretary DILLON. That is correct.

Senator KERR. And if they use the intelligence to the same high degree of efficiency in spending the money as they did in making the money, they are going to spend it where they can make the most money out of what they spend, are they not?

Secretary DILLON. That is absolutely correct.

Senator KERR. It is your position that under present environment the inducement is greater to them to spend that money for increased and additional productive facilities in other highly industrialized countries than to spend it here?

Secretary DILLON. In many cases that is correct.

Senator KERR. And it is to overcome that adverse influence or the overcoming or the lessening of that adverse influence which is one of the reasons for your recommendation of this provision?

Secretary DILLON. It is one of the major reasons; yes, sir.

Senator KERR. That is all, Mr. Chairman.

The CHAIRMAN. Mr. Secretary, have you got the figure on the total amount spent for modernization of plants in this country?

Secretary DILLON. We have already submitted that, it appears in table 3 of exhibit 1–B.

The CHAIRMAN. We will recess until 2:30 this afternoon.

(Whereupon, at 1 p.m., the committee recessed, to reconvene at 2:30 p.m., the same day.)

AFTERNOON SESSION

The CHAIRMAN. The committee will come to order.

Mr. Secretary, I have just a few questions here.

The investment credit can only benefit those taxpayers who have sufficient cash or credit to buy more equipment. Because of this, will not the credit increase the advantage that the large business holds over small business, because large business, generally speaking, can raise capital more readily?

STATEMENT OF HON. DOUGLAS DILLON, SECRETARY OF THE TREASURY—Resumed

Secretary DILLON. I do not think so, Mr. Chairman, and that is not the opinion of the Small Business Men's Association. These small businesses, because of the particularly favorable aspect of the credit for them, will have a very great benefit.

Now, of course, the business that does not make any money at all will not benefit from the investment credit and will not benefit from any form of depreciation practice.

There has to be a business that is making some money. But, assuming that it is a small business which makes some money, which, of course, the great majority do, I think that the record will show that this incentive will be more favorable to small business than any possible change and improvement in depreciation practice.

The CHAIRMAN. Have you any figures of those companies that would do this modernization, regardless of the tax incentive?

Secretary DILLON. Mr. Chairman, I did get these figures. They are all in this annex 1, showing the amount of money that has been spent on new plant and equipment in 1939, and then from 1945 to 1946, and it shows that overall on new plant and equipment we spent in the last—from 1956 on, we have spent $35 billion, roughly, or a little less. It ran a little over that, about $37 billion, in 1957.

Every year since then, it has been less, and what was spent in 1961 was less than in 1956. So there has been no increase at all in that period.

But I assume that something like this would be spent, in any event, and I assume that, as our economy grows, the expenditures would grow with it. However, they are not adequate in relation to the size of our economy.

What we are trying to do is to have a more adequate percentage of our gross national product spent in plant and equipment, Mr. Chairman.

The CHAIRMAN. The figures that you have just given, this is only for equipment?

Secretary DILLON. Plant and equipment.

The CHAIRMAN. Plant?

Secretary DILLON. Plant and equipment. We have got them for plant and equipment; we have got them just for equipment. I can give you either.

Just for equipment, it shows that we spent $27.2 billion in 1956; it reached a high of $28.5 billion in 1957; and it has been lower every year since then. Last year it was $25.7 billion, which was 4.9 percent of our gross national product, which is the lowest amount that has been spent since, these figures show, in 1947, which is the first year that I have here. For the last 15 years, this is the smallest amount.

The CHAIRMAN. How much do you think that this incentive will increase that expenditure?

Secretary DILLON. Well, the expenditure rate of other industrial countries varies.

The United States dropped from 1950, which was about 6.5 percent, down through the years to this 4.9 percent last year, whereas the Common Market countries, as an average, have increased from 8.5 percent up to something over 10 percent. The various countries in the Common Market have different percentages.

But I would think and hope that this investment credit would lead to an increase of maybe up to 7 or 8 percent, something of that nature, which would make a very radical difference and would be of tremendous help in stimulating our economy and the competitiveness of our business against foreign competition.

The CHAIRMAN. The loss of $1.4 billion, that is based on what percent of increase?

Secretary DILLON. The loss of $1.4 billion is based just on what we would expect to have spent this year. That particular figure is not based on any percentage increase.

The CHAIRMAN. It could be more, or it could be less, could it not? I mean that is not a fixed figure?

Secretary DILLON. No.

The CHAIRMAN. It depends on how many industries take advantage?

Secretary DILLON. That is correct.

As the figures were shown in a memorandum that the joint committee staff, Mr. Stam, gave you, this indicates a steady rise in expenditures for equipment and postulates a 5-percent annual increase over the years in the expenditures for plant and equipment. Of course, that is not what has happened in past years, but it is what we think would happen with this procedure, and that was the basis on which those figures were figured by the joint committee staff.

The CHAIRMAN. What is the average increase, then?

Secretary DILLON. In the United States?

The CHAIRMAN. Say, in the last 5 years; what is the average increase, percentagewise?

Secretary DILLON. Zero.

There has been a decrease.

The CHAIRMAN. You mean the money spent for modernization?

Secretary DILLON. Is smaller now than it was 5 years ago.

The CHAIRMAN. If course, there are more plants.

Secretary DILLON. That is right.

We are spending on more plants less than we spent on fewer plants 5 years ago.

The CHAIRMAN. What I am trying to arrive at, what is your estimate of increasing the present amount? Even though it is minor, it must be something.

Secretary DILLON. We think that the credit will make an increase of at least more than 5 percent a year, but we use that 5 percent a year in our——

The CHAIRMAN. That is your tax calculation?

Secretary DILLON. Yes.

Looking ahead for 10 years, that is what we use, but we think it will be more than that.

The CHAIRMAN. That is the $1.4 billion loss?

Secretary DILLON. For this year, when we calculated losses, we calculated $1,350 million; and the Joint Committee $1.4 billion. That was based just on estimates of the Department of Commerce and the Securities and Exchange Commission as to how much was apt to be spent for equipment this year. It does not take into account any stimulating effects of the credit. So there could be a larger figure, if the credit works and more money is spent on plant and equipment. But then, of course, we would be getting profits from that extra business. We would be getting taxes from those extra profits.

The CHAIRMAN. In other words, you think that if this plan is adopted, there will be a 5 percent increase each year?

Secretary DILLON. I would say at least, yes, on the average.

The CHAIRMAN. Then you agree with Mr. Stam that in 10 years the loss should be $20 billion?

Secretary DILLON. I think that Mr. Stam's figures are based, as he says in his table, on an assumed rate of growth of investment of 5 percent—I assume that because that is the figure we used—he mentions that that is the figure that Treasury had taken.

I do not think he tried to compute any separate rate of growth. He just took the same one we did.

The CHAIRMAN. If it is successful, you will lose more in taxes as the years go on, as you do now?

Secretary DILLON. No, sir.

We will gain in taxes because there will be more business; more people will be hired; more people will be at work; and there will be more profits; and we will make up from those more profits, certainly, as much as we lose on this particular incentive.

The CHAIRMAN. That may be wishful thinking, may it not, just like these deficits?

Secretary DILLON. It could be, but it has been the consistent position of the Treasury for the last 10 or 15 years that that is the way incentives work.

The CHAIRMAN. If the same accuracy would be applied to these deficits—I have not seen an accurate estimate, yet, and I have been here a long time.

You recognize that?

Secretary DILLON. I recognize that. It is very difficult to forecast business conditions.

The CHAIRMAN. It is very difficult to forecast, also, how much more goods it will make and how much more profit it will make by reason of this bill, is it not?

Secretary DILLON. It is difficult, but if you have more profitability, you can only assume that business will recognize that; there will be more business; and, therefore, you will get more taxes.

It is very difficult, exceedingly difficult, to measure that.

The CHAIRMAN. I have no doubt this is your best judgment, but, after all, it is a guess?

Secretary DILLON. That is right.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Mr. Secretary, as I understand it, the basis of your recommending this 8 percent investment credit is because of a concern which you have over the declining rate of expansion of American industry, is that correct?

Secretary DILLON. Not necessarily just rate expansion. It is rate of modernization, as well as expansion. It is rate of expenditure on plant and equipment, particularly equipment.

Senator WILLIAMS. And you cited the decline as beginning in 1957, is that correct?

Secretary DILLON. It is most marked there. The figures show that it has been going on fairly regularly right from 1947, when we had 7.1 percent of our national product that went into producing durable equipment.

That increased in 1948 to 7.3 percent, and then declined right after: 6.7, 6.6, 6.5, 6.1, and so forth.

It has now gotten down to 4.9 percent.

Senator WILLIAMS. Would not part of that high rate immediately after the war be the result of the fact that for the 5-year period of the war they were unable to keep their plants in a proper state of repair?

Secretary DILLON. I would think so.

I would think that is probably right.

Then maybe if we want to pick a better time, we can pick 1951 and 1952, when it was 6 percent or so. Now it is down below 5 percent.

Senator WILLIAMS. When did we repeal the 5-year amortization rates?

Secretary DILLON. When that was repealed I do not know. I do not have that in my mind.

Senator WILLIAMS. It was about 1957, was it not, and would not that have served as some incentive for the modernization of plants during that period?

Secretary DILLON. Oh, it certainly did.

I think you can see there is an effect here which, I think, was due to the adoption of the double declining depreciation method, probably, where in the years 1956 and 1957 there was a temporary increase, and then that increase has fallen off and stayed lower ever since then.

There was an increase in 1956 to 6.5 percent from 5.8 the year before, and that level was pretty well held in 1957, when it was 6.4 but, thereafter, it went back down to 5.2, 5.4, 5.5, and 4.9.

Senator WILLIAMS. I think your assistants, I understand, have this date on the repeal of the 5-year amortization?

Secretary DILLON. I am sure they have, yes.

Senator WILLIAMS. Would they furnish that at this point, if they do?

Secretary DILLON. Yes.

(The information referred to was later submitted for the record as follows:)

Amount of investment certified for 5-year amortization

[In millions of dollars]

Year	Amount	Year	Amount
1951	6,781	1955	2,071
1952	6,766	1956	2,673
1953	2,606	1957	752
1954	1,061	1958	87

NOTE.—Certifications for 5-year amortization after Aug. 22, 1957, were limited to certain specialized types of investment directly related to defense. No certifications were permitted after Dec. 31, 1959.

As the above table indicates, the major impact of the 5-year amortization program was felt in 1951 and 1952.

Source: Office of the Secretary of the Treasury, Apr. 4, 1962, Office of Tax Analysis.

Senator WILLIAMS. I notice in your statement you make this statement, and I am quoting:

> It is essential to our competitive position in markets, both here at home and abroad, that American industry be put on the same basis as foreign industry.

An then later you refer to certain countries in Europe as having already adopted a formula similar to that which you are proposing now; is that correct?

Secretary DILLON. Certain countries have similar formulas. Others have other types of formulas which provide the same sort of incentives, either large first-year special initial allowances or something of that nature.

Senator WILLIAMS. Do any or all of those countries allow industry to write off more than 100 percent of the cost?

Secretary DILLON. Yes. That is the case in England, Belgium, and in Holland, which have the same or a similar thing to what we have. They call it there an investment allowance.

In their case, instead of a tax credit, it is taken before profits are computed, in the same manner as depreciation, but it is an allowance over and above the 100-percent level. It is a special allowance that is just taken the first year, and then they permit 100 percent depreciation, in addition to that, Senator Williams.

Senator WILLIAMS. Now, how much is that credit for those respective countries?

Secretary DILLON. Well, in England it is 20 percent, which would be the equivalent of a 10 percent investment credit here. We have got the figures. In fact, maybe I ought to submit for the record here a compilation which we made of some 43 pages which goes into detail on the depreciation practices in all these foreign countries and gives the full detail on each country.

Senator WILLIAMS. You wanted to submit that report, you mean?

Secretary DILLON. Yes. I think that would be a useful thing to give you those facts.

The CHAIRMAN. That will be included in the record.

(The compilation referred to is as follows:)

DEPRECIATION PRACTICES IN CERTAIN FOREIGN COUNTRIES

The following outline is designed to provide information on depreciation practices in leading foreign industrial nations. Countries surveyed are Belgium, Canada, France, West Germany, Italy, Japan, Netherlands, Sweden, and United Kingdom. Replies to a questionnaire sent by the Treasury Department to the United States embassies in the various countries were the main source of data. Among the additional references consulted were published and unpublished material from the World Tax Series, prepared by the Harvard Law School International Program in Taxation; Taxation in Western Europe, published by the Federation of British Industries; Common Market Fiscal Systems, by E. B. Nortcliffe; Canadian Tax Reporter, published by CCH Canadian Limited; and Information Guide for Those Doing Business Outside the United States of America, published by Price Waterhouse & Co.

The information for each country has been classified under general headings as follows:

Corporate tax rate.—This section is designed to give the approximate rate of tax imposed on income of industrial corporations.

Method of computing depreciation.—The various methods (straightline, declining-balance, etc.) of depreciation permitted or required to be used, together with any limitations on the use of a particular method, are covered in this section.

Rates of depreciation.—The method by which adepreciation rates for assets are determined (i.e., statutory rates, negotiations with individual taxpayers, etc.) is discussed in this section, together with the treatment of salvage value and the relationship of straightline and declining-balance rates of depreciation. It is difficult to determine with any degree of certainty the useful lives or rates of depreciation allowed in countries where statutory lives or rates are not provided. Just as tax lives of assets in the United States may vary widely from the administrative Bulletin "F" publication, lives may also differ considerably in foreign countries as a result of administrative practices. Thus, the rates of depreciation listed for individual assets in these countries must be regarded as rough averages from which a considerable degree of dispersion might be expected.

Types of buildings or equipment not subject to depreciation.—Listed here are assets, which would be depreciable under U.S. depreciation provisions, but on which depreciation is not permitted to be deducted in the foreign country.

Accelerated depreciation.—Under this heading are discussed initial or first-year depreciation allowances and statutory reduction of lives of assets. Countries having general provisions for initial or first-year allowances are France, Italy, Netherlands, and the United Kingdom, while Italy also has a general provision for reduction of lives. Special allowances, applicable only to certain assets or industries, are also permitted in a number of the countries.

Incentive allowances.—This topic covers provisions for deducting allowances in excess of the cost of the asset, but not including deductions based on the change in the price level. Countries currently having incentive allowances are Belgium, Netherlands, and the United Kingdom.

Adjustments for price level changes.—None of the countries covered currently permit adjustment for changes in the price level, although they have previously been permitted in Belgium, France, West Germany, Italy, and Japan. How-

ever, these prior adjustments, generally, may be used in computing current depreciation allowances on assets purchased prior to the time of the latest revaluation.

Treatment of gains on sale of depreciable property.—Under this heading are discussed any special provisions for the taxation of gains on the sale of depreciable assets. Also discussed are provision for the deferral of recognition or gain upon reinvestment of proceeds of sale.

Treatment of losses on sale of depreciable property.—The tax treatment of loss on sale of depreciable property is covered under this heading.

Relationship of book and tax depreciation.—Provisions limiting tax depreciation deductions to depreciation recorded on the books of account is covered in this section.

Provisions of prior law.—Expired provisions of the law, concerned either with accelerated depreciation or incentive allowances, are outlined under this heading.

BELGIUM

Corporate tax rate

The maximum effective rate of tax (after taking into account the deductibility of the previous years' tax from the current year's taxable income) is 30 percent on undistributed profits. The maximum effective rate on profits distributed as dividends is 47.2 percent.

Method of computing depreciation

The straight-line method of depreciation is used almost exclusively.

Rates of depreciation

Depreciation rates are determined by negotiation between the taxing authorities and individual taxpayers on a case-by-case basis. The fact that an asset may have a shorter useful life than its physical life may be taken into account in determining the rate of depreciation. Generally, salvage value is not considered in computing depreciation deductions. The following might be considered as average for negotiated depreciation rates:

	Percent
Industrial equipment	10–20
Office furniture	10
Industrial buildings	3–5
Trucks and cars	20–25

Types of buildings or equipment not subject to depreciation

Commercial buildings and administrative offices are not subject to depreciation.

Accelerated depreciation

There are no general provisions for accelerated depreciation. However, special accelerated treatment is given maritime and inland vessels. Depreciation is allowed vessels at the rate of 20 percent in the first year, 15 percent in each of the 2 succeeding years, and 10 percent in each of the following 8 years.

Incentive allowances

A special deduction is allowed for 30 percent of the excess of investment during the year in industrial property over the sum of (1) depreciation for such year on property held at the close of the preceding tax year and (2) the proceeds realized during the year from the sale of land, buildings, machinery, and certain investment securities. The deduction is available only if the excess if more than BFr30,000 ($600). The special deduction was enacted originally for 1959 and 1960 and has been extended to 1961 and 1962. The deduction is normally distributed in equal amounts of 10 percent over a 3-year period beginning in the year in which the investment is made. However, if the profits in any year are insufficient, the unused portion of the deduction may be carried forward for 5 years. The deduction does not affect the depreciation allowance otherwise available on the property. Thus, the total of the special deduction and depreciation will exceed the cost of the property. The special deduction gives a maximum benefit of 9 percent of the investment (30 percent of the 30 percent maximum effective tax rate on undistributed profits). Since the deduction applies only to the undistributed profits tax, the result is, in a sense, only a tax deferment, with the deferred tax being collected at the time of distribution of the profits as dividends.

The deduction is available only to industrial enterprises engaged in the extraction, fabrication, or transformation of items. It does not apply, for example, to farmers, transportation firms, hotels, and beauty parlors. The source of funds used for the investment is not restricted. The tax incentive is aimed at expansion rather than mere replacement and, for this reason, the proceeds from the sale of capital assets during the year must be subtracted from the qualified expenditures during the year. Thus, an enterprise which replaces its buildings or machinery with other buildings or machinery of the same value does not obtain the benefit of the deduction. Investment qualifying for the special deduction must be made in business real property and machinery. Such property includes land bought on which to erect industrial buildings as well as business buildings, apparatus, tools, office equipment and furniture, and laboratory equipment. It is immaterial whether the taxpayer buys new or used items. However, leased equipment may not be taken into account either by the lessor or the lessee. Only investments in items used in Belgium qualify for the deduction, although there is no rule that the items acquired must have been made in Belgium. Items under contract but not yet delivered may be taken into account to the extent that progress payments are made during the year. For new enterprises the entire amount of the investment during the first year qualifies for the special deduction.

Adjustments for price level changes

Taxpayers were allowed in 1947 to revalue assets acquired before December 31, 1940. Subsequent depreciation deductions are permitted on the basis of such revaluation in order to make allowance for the extraordinary rise in prices during and immediately after the war.

Treatment of gains on sale of depreciable property

Generally, gains on the sale of buildings and equipment are treated as ordinary income in the case of corporations. However, under a law enacted in 1959 and subsequently extended to 1962, only one-fifth of the gain is subject to tax if the proceeds of sale are reinvested in fixed assets or equipment located in Belgium. Total exemption of the gain is permitted if the reinvestment is made in designated regions which have suffered from high rates of unemployment.

Treatment of losses on sale of depreciable property

Losses on the sale of buildings, equipment, and machinery are fully deductible from income.

Relationship of book and tax depreciation

Depreciation allowed for tax purposes is limited to the amount shown on the books.

Provisions of prior law

A special deduction of 30 percent for "productive investment" in excess of BFr250,000 (approximately $5,000) per year was allowed between mid-1954 and mid-1956. This deduction was spread over a 3-year period and was independent of the depreciation deduction. It differed from the special deduction introduced in 1959 in that it was not related to depreciation or the proceeds from the sale of capital assets.

CANADA

Corporate tax rate

The maximum corporate tax rate is 50 percent including the 3 percent old age security tax.

Method of computing depreciation

With the exception of certain farmers and fishermen permitted to use the straight-line method, all taxpayers are required to compute depreciation under the declining-balance method. Under the declining-balance method, depreciable assets are grouped into classes set forth in the income tax regulations, and depreciation is computed with respect to each class as a whole rather than for individual assets.

Rates of depreciation

The rates of depreciation which must be used under the declining-balance method are set forth in the income tax regulations. Under these regulations, all depreciable assets are grouped into classes with a specified maximum rate applying to each of the classes of assets. The classes and declining balance rates of depreciation are as follows:

Class 1 (4 percent): Property not included in any other class that is (*a*) a bridge, (*b*) a canal, (*c*) a culvert, (*d*) a dam, (*e*) a jetty, (*f*) a mole, (*g*) a road, sidewalk, airplane runway, parking area, or similar surface construction, (*h*) railway track and grading that is not part of a railway system, or (*i*) tile drainage.

Class 2 (6 percent): Property that is (*a*) electrical generating equipment, (*b*) a pipeline for oil, gas or water, and (*c*) with certain exceptions, generating and distributing equipment and plant (including structures) of producers or distributors of electrical energy, gas, water, or heat.

Class 3 (5 percent): Property not included in any other class that is (*a*) a building or other structure, including component parts such as electrical wiring, plumbing, sprinkler systems, air-conditioning equipment, heating equipment, lighting fixtures, elevators and escalators, (*b*) a breakwater (other than a wooden breakwater), (*c*) a dock, (*d*) a trestle, (*e*) a windmill, or (*f*) a wharf.

Class 4 (6 percent): Property, that would otherwise be included in another class that is (*a*) a railway system or part thereof, or (*b*) a tramway or trolley bus system or a part thereof.

Class 5 (10 percent): Property that is (*a*) a chemical pulp mill or ground wood pulp mill, but not including hydroelectric powerplants and their equipment, or (*b*) an integrated mill producing chemical pulp or ground wood pulp and manufacturing therefrom paper, paperboard or pulpboard, but not including hydroelectric powerplants and their equipment.

Class 6 (10 percent): Property not included in any other class that is (*a*) a building of frame, log, stucco on frame, galvanized iron, or corrugated iron construction including component parts, (*b*) a wooden breakwater, (*c*) a fence, (*d*) a greenhouse, (*e*) an oil or water storage tank, (*f*) a railway tank car, (*g*) a wooden wharf, or (*h*) an aeroplane hangar acquired after 1958.

Class 7 (15 percent): Property that is (*a*) a canoe or rowboat, (*b*) a scow, (*c*) a ship, (*d*) furniture, fitting or equipment (except radar and radio equipment) attached to a property included in this class, (*e*) a spare engine for property included in this class, (*f*) a marine railway, or (*g*) a ship under construction.

Class 8 (20 percent): Property that is a tangible capital asset that is not included in another class (except an animal, a tree, shrub, herb, or similar growing thing, a gas well, a mine, an oil well, radium, a right-of-way, a timber limit, and tramway tracks).

Class 9 (25 percent): Property that is (*a*) auxiliary electrical generating equipment of a taxpayer not engaged in business of distributing electrical energy, (*b*) radar equipment, (*c*) radio transmission equipment, (*d*) radio receiving equipment, or (*e*) electrical generating equipment having a maximum load capacity of not more than 15 kilowatts.

Class 10 (30 percent): Property not included in any other class that is (*a*) automotive equipment, (*b*) harness or stable equipment, (*c*) a sleigh, (*d*) a trailer, or (*e*) a wagon, and property that would otherwise be included in another class that is (*f*) a building acquired for the purpose of gaining or producing income from a mine, (*g*) contractor's movable equipment, (*h*) a floor of a roller-skating rink, (*i*) gas or oil well equipment that is normally used above ground, (*j*) mining machinery and equipment, (*k*) property acquired for cutting and removing timber which will be of no further use to the taxpayer after all merchantable timber has been removed from a timber limit, (*l*) mechanical equipment acquired for logging operations, (*m*) access roads and trails for the protection of standing timber against fire, insects, and disease, or (*n*) property that was acquired for a motion picture drive-in theater.

Class 11 (35 percent): Property not included in any other class that is an electrical advertising sign owned by the manufacturer thereof and used to earn rental income.

Class 12 (100 percent): Property not included in any other class that is (*a*) a book that is part of a lending library, (*b*) chinaware, cutlery, or other tableware, (*c*) a kitchen utensil costing less than $100, (*d*) a die, jig, pattern, mold, or last, (*e*) a medical or dental instrument costing less than $100, (*f*) a mine shaft, main haulageway or similar underground work, sunk or constructed after the mine came into production, (*g*) linen, (*h*) a tool costing less than $100, (*i*) a uniform, (*j*) the cutting or shaping part of a machine, (*k*) apparel or costume used for the purpose of earning rental income therefrom, and (*l*) video tape.

Class 16 (40 percent): Property that is (*a*) an aircraft, (*b*) furniture, fittings, or equipment attached to an aircraft, or (*c*) a spare part for a property included in this class.

Class 17 (8 percent): Property that would otherwise be included in another class, that is a telephone or telegraph system or a part thereof, except radio receiving and transmission equipment and property included in class 10.

A taxapayer may elect to include in class 1 all properties which would otherwise be included in another class, or a taxpayer whose chief depreciable properties are in class 2, 4, or 17, may elect that any other property from the same business be included in class 2, 4, or 17.

Types of buildings or equipment not subject to depreciation

None.

Accelerated depreciation

A special depreciation allowance to encourage reequipment and modernization was part of the 1961 budget proposals to encourage and assist Canadian business to become more competitive in markets abroad and at home. The purpose of the allowance is to help business undertake new capital installations including machinery, equipment, and buildings.

The reequipment and modernization allowance takes the form of a 50 percent increase in the rates of capital cost allowance for the year in which a new asset is acquired. This additional allowance will apply to new assets acquired in the period June 21, 1961, to March 31, 1963. Since this allowance is intended to encourage reequipment and modernization it applies only to those capital expenditures which are in excess of normal or ordinary capital expenditures. The regulations provide that the expenditures which qualify for the additional allowance are those made in the taxation year which exceed a certain base amount. The base amount is the aggregate of the amounts spent for depreciable property acquired in the last complete taxation year of the taxpayer ending before June 21, 1961, or the average for the last 3 years if the average is smaller. In order to guard against existing operations being split up into new ones for tax-savings purposes, there are provisions for the carryover of base expenditures in the case of certain incorporations and reorganizations.

Nearly all assets depreciable on the diminishing balance basis will qualify for the additional allowance. Property which is already eligible for accelerated depreciation under a certificate issued by the Minister of Defense Production, and property which is already eligible for a 100 percent rate of depreciation does not qualify for the new allowance. In addition, second-hand assets are not eligible nor is property acquired for use entirely outside Canada.

The amount of capital expenditures qualifying for the allowance is the excess of the aggregate expenditures over the base amount. The excess is not computed on the basis of expenditures for various classes of assets under the Canadian class depreciation system. Thus, qualifying expenditures might all be for automobiles, while the base period expenditures were for buildings. If the taxpayer has acquired property of more than one class, he may allocate the qualifying expenditures in any manner he desires to the various classes of acquisition.

The following example illustrates the operation of this allowance:

Computation of base amount: Assume that capital expenditures for depreciable property for 1958, 1959, and 1960 (the last complete taxation year ending before June 21, 1961) were $60,000, $50,000, and $40,000, respectively. The base amount would be $40,000 since this is less than the 3-year average expenditures of $50,000.

Computation of amount on which additional allowance may be claimed:

Purchases of depreciable property in 1962:	
Buildings (class 3)	$20,000
Machinery (class 8)	30,000
Automotive equipment (class 10)	15,000
Total	65,000
Base amount	40,000
Amount on which additional allowance may be claimed	25,000

The taxpayer may claim the additional allowance with respect to any of the property acquired by him in 1962. Assume the following allocation:

Buildings (class 3)	0
Machinery (class 8)	$10,000
Automotive equipment (Class 10)	15,000
Total	25,000

The additional allowance would be computed as follows:

	Normal rate	Rate of additional allowance	Cost of property	Allowance
	Percent	*Percent*		
Machinery	20	10	$10,000	$1,000
Automotive equipment	30	15	15,000	2,250
Total				3,250

The taxpayer's total deductions under the class system would be computed as follows given the undepreciated cost at December 31, 1961, and disposals credited to the accounts during the year:

	Class 3, 5 percent	Class 8, 20 percent	Class 10, 30 percent	Total
Undepreciated cost at Dec. 31, 1961	$110,000	$135,000	$5,000	$250,000
Additions, 1962	20,000	30,000	15,000	65,000
Disposals, 1962		(5,000)	(6,000)	(11,000)
Total	130,000	160,000	14,000	304,000
Normal allowance	6,500	32,000	4,200	42,700
Additional allowance		1,000	2,250	3,250
Depreciation, 1962	6,500	33,000	6,450	45,950
Undepreciated cost at Dec. 31, 1962	123,500	127,000	7,550	258,050

Another form of accelerated depreciation may be claimed in respect of most types of assets acquired after 1960 which are used either (1) in making a product not previously produced in Canada or (2) in making a product not previously produced in an area of labor surplus. The taxpayer must apply to the Minister of Trade and Commerce for certification of the project as qualifying under the regulations. Structures, machinery, and equipment, and patent and license costs are eligible for the special allowance. No distinction is made between new and used assets. However, office furniture and equipment, automobiles, and assets having a capital cost allowance rate in excess of 30 percent are not eligible. The additional allowance is equal to the maximum normal allowance for the year in which the assets are acquired. The full amount of the allowance may be taken in the year of acquisition of the assets or in either of the two years following acquisition or the allowance may be apportioned in any manner over these three years. The additional allowance reduces the undepreciated cost of the asset and thus also reduces the normal depreciation allowance in the following years. Both this allowance and the reequipment and modernization allowance discussed above may be claimed with respect to the same property. Special provisions are also in effect for accelerated writeoff of certain coal property, fishing vessels and defense facilities.

Incentive allowances

None.

Adjustment for price level changes

None.

Treatment of losses on sale of depreciable property

Under the Canadian class system, gains and losses as such are not computed upon the sale of depreciable property. Proceeds up to the amount of the original cost of the assets sold from a class during a taxable year are deducted from the undepreciated cost of the remaining assets in the class. Any proceeds which exceed the original cost of the assets sold constitute a capital gain not subject to income tax. Under "recapture" provisions, proceeds applied in reduction of the undepreciated cost which exceed the remaining undepreciated cost of the class are required to be included in ordinary income and are taxed at ordinary tax rates. Any undepreciated cost remaining after a taxpayer has disposed of all property in a class and has no property of that class at the end of a taxable year, may be deducted as a "terminal loss" from ordinary income. In general, the operation of the class system results in (1) the deferral of recognition of gain on the sale of depreciable property along with a reduction of future depreciation deductions, (2) deferral of losses on sale of depreciable property with an increase in future depreciation deductions, (3) ultimate recognition as ordinary income of gains on sale of depreciable property to the extent of depreciation previously claimed and ultimate recognition as ordinary deductions of losses on sale of depreciable property.

The following examples illustrate the operation of the class system with respect to disposals of property of a particular class:

	1	2	3	4	5
Original cost of assets in class	$100,000	$100,000	$100,000	$100,000	$100,000
Accumulated depreciation	75,000	75,000	75,000	40,000	50,000
Undepreciated cost before disposition	25,000	25,000	25,000	60,000	50,000
Dispositions:					
Original cost	35,000	35,000	35,000	20,000	100,000
Proceeds	20,000	30,000	40,000	50,000	40,000
Proceeds deducted from undepreciated cost	20,000	25,000	25,000	20,000	40,000
Capital gain	0	0	5,000	30,000	0
Ordinary income under "recapture" provisions	0	5,000	10,000	0	0
Ordinary loss under "terminal loss" provisions	0	0	0	0	10,000
Undepreciated cost remaining	5,000	0	0	40,000	0

Relationship of book and tax depreciation

Depreciation is allowed for tax purposes without regard to the amount of depreciation recorded on the books. For the years 1949–53, depreciation could be deducted for tax purposes only to the extent that it had been recorded on the books. This provision was repealed effective for 1954 and subsequent years.

Provisions of prior law

In general, depreciation was deferred on assets purchased after April 10, 1951, and before January 1, 1953, unless the Minister of Trade and Commerce had issued a certificate of eligibility for depreciation. The original term of deferment was 4 years. However, this restriction was lifted and beginning in 1953 depreciation was allowed to commence on such assets.

FRANCE

Corporate tax rate

The corporate income tax rate is 50 percent.

Method of computing depreciation

For all depreciable assets acquired prior to January 1, 1960, straight-line depreciation continues in effect until the assets are fully depreciated. The declining-balance method becomes mandatory for certain types of assets acquired after January 1, 1965. The taxpayer has an election to apply the declining-balance method to qualifying assets acquired between January 1, 1960, and January 1, 1965, or may continue using the straight-line method. However, the same system must be applied to all assets acquired during this period to which the election applies. It should be noted that the various special acceleration provisions will, in general, continue to apply under the straight-line method, but may not be used in conjunction with the declining-balance method.

Assets qualifying for the declining-balance method must be new when acquired by the taxpayer and have a normal useful life of more than 3 years. The following types of assets qualify for depreciation under the declining-balance method: (1) machinery and equipment used in industry for manufacture, transformation, or transport; (2) handling equipment; (3) water and air purification installations; (4) installations for the production of steam, heat, or energy (5) firedetection and firefighting equipment, burglar alarms, and industrial safety devices; (6) medical equipment; (7) business machines, except typewriters; (8) machinery and equipment for scientific and technical research; (9) equipment for the storage of merchandise; and (10) all buildings and equipment of enterprises in the hotel business (lodging or meals and lodging) but excluding installations for enterprises in the restaurant business only. Other types of assets must be depreciated under the straight-line method. Such types include all buildings, except hotel buildings, trucks of less than 2-ton capacity, passenger cars, buses, office furniture, and typewriters.

Under the declining-balance method, a switch to the straight-line method may be made when the point is reached at which the straight-line method produces a greater annual deduction than the declining-balance method.

Rates of depreciation

Rates of depreciation must be "within limits of those customarily applied in each branch of industry, commerce, or business." Negotiations for rates are in most instances with individual taxpayers, but may sometimes be with industrial groups. Factors such as obsolescence and particularly intensive use may be taken into account in determining depreciation rates. Typical rates under the straight-line method are:

	Percent
Industrial buildings	5
Commercial buildings or housing	2–3
Machinery and office furniture	5–10
Motor vehicles	20–25

The rates under the declining-balance method are determined by applying coefficients to the straight-line rates. The coefficients are 1.5 for assets having a normal useful life of 3 or 4 years, 2 for assets having a life of 5 or 6 years, and 2.5 for assets having a life of longer than 6 years.

Types of buildings or equipment not subject to depreciation

None.

Accelerated depreciation

As explained above, the declining-balance method is mandatory for certain categories of assets acquired after January 1, 1965, and may be elected for qualifying assets acquired between January 1, 1960, and January 1, 1965. A number of forms of accelerated depreciation have been in effect and continue in effect for assets acquired between January 1, 1960, and January 1, 1965, if the taxpayer continues to use the straight-line method. However, these acceleration provisions do not apply if the taxpayer elects to use the declining-balance method with respect to such assets.

For office equipment—other than typewriters—handling equipment, water and air purification equipment, equipment for production of steam, heat, or energy, security equipment, and equipment for scientific research acquired new after January 1, 1954, and utilized for purposes of modernization, a 10-percent initial allowance is permitted. If the 10-percent allowance is claimed, other depreciation deductions are on the basis of 90 percent of cost. For orders placed between May 29, 1959, and January 1, 1960, the 10-percent initial allowance was extended to: (1) machine tools for metalworking and other named industries; (2) machine tools having a life of at least 5 years for the food, rubber, plastic, ceramics, shoe, textile, paper, and certain other industries: (3) equipment of building contractors having a life of at least 5 years: (4) trucks weighing 5 tons or more; and (5) various kinds of electrical and radiological equipment.

New machinery with a useful life of at least 5 years, if used in industry for manufacture, transformation, handling, or transportation, is subject to accelerated depreciation. This accelerated depreciation takes the form of a double deduction in the first year. The taxpayer, under this procedure, computes annual depreciation for each year in the normal manner, takes two annual deductions in the first year, and the period of depreciation deductions is reduced by 1 year.

For qualifying equipment, both the 10-percent initial allowance and the double deduction in the first year may be claimed. The following table compares the annual deductions available under the straight-line method assuming the 10-percent initial allowance and double deduction in the first year are both applicable with the deductions available under the declining balance method for a $1,000 asset having a useful life of 10 years.

Year	Straight-line method with 10-percent initial allowance and double deduction in 1st year	Declining-balance method	Year	Straight-line method with 10-percent initial allowance and double deduction in 1st year	Declining-balance method
1	280	250.0	6	90	59.0
2	90	188.0	7	90	44.5
3	90	141.0	8	90	44.5
4	90	105.0	9	90	44.5
5	90	79.0	10	0	44.5

Under a 1958 provision, 50 percent of the cost of buildings or machinery acquired for scientific or technical research may be deducted in the first year. The remainder of the cost is deducted in the normal manner over the useful life of the facilities.

In order to stimulate exports, a special "export" depreciation deduction was established in 1957. The amount of the deduction is determined by multiplying the ordinary depreciation allowance for the year by the ratio between the firm's export sales and total sales for the year. In 1959, this deduction was increased by 50 percent. Steel and coal companies have been permitted to use "output" depreciation based upon a percentage of sales or output.

To encourage modernization of facilities, newspapers and magazines were allowed to expense their acquisitions, writing off the cost of equipment in full, in the year of acquisition. They are also entitled to deductions for certain amounts put in reserve for future acquisition of equipment. The 1961 Finance Act extended these incentives for another 2 years.

Incentive allowances

None.

Adjustments for price level changes

From 1945 through 1958, taxpayers were permitted an annual revision of their balance sheets to reflect, by the use of government-specified coefficients, the decline in the purchasing power of the franc. Depreciation and gain or loss on the disposition of assets were computed on such revalued amounts. Under a 1959 law revaluation was abolished. However, firms were permitted (mandatory for taxpayers with an annual turnover of more than 500 million old francs) a final revaluation as of June 30, 1959. Such revaluation is made by multiplying the cost of the asset (less, where taken, any 10-percent initial allowance claimed) by a stipulated coefficient for the year of acquisition. Similarly, each annual depreciation allowance applicable to the asset is multiplied by the coefficient for the year for which the depreciation was claimed. The total of the revalued depreciation allowances is subtracted from the revalued cost of the assets to obtain a new value which is used as the basis for computing annual depreciation allowances for the remainder of the useful life of the asset. The difference between the old value of the asset and the new value constitutes a special valuation reserve and a tax of 3 percent was imposed on the amount of such reserve. The coefficient of revaluation for depreciable assets acquired in 1914 and prior is 243; 1924, 51.8; 1935, 64.8; 1944, 16.3; 1954, 1.25.

Treatment of gains on sale of depreciable assets

Gains on sale of depreciable assets are taxable at ordinary income tax rates. However, the taxpayer may defer the taxation of the gain by reinvesting the proceeds of sale in other capital assets within 3 years following the end of the year within which the sale took place. The reinvested gain serves to reduce the basis of the assets in which reinvestment is made.

Treatment of losses on sale of depreciable property

Losses on sale of depreciable property may be deducted in full from ordinary income.

Relationship of book and tax depreciation

A taxpayer may deduct for tax purposes only such depreciation as is actually recorded in the books of account.

WEST GERMANY

Corporate tax rate

The corporate tax rate is 51 percent on retained income and 15 percent on income distributed as dividends.

Method of computing depreciation

Either the straight-line method or the declining-balance method may be used in depreciating movable property. However, only the straight-line method may be used in computing depreciation on buildings. Individual items costing not more than DM600 (approximately $150) may be fully written off in the year of acquisition.

Rates of depreciation

Depreciation rates are based on the economic life expectancy of the assets under the particular conditions of the taxpayer. Rates are negotiated between the tax authorities and individual taxpayers. Unusual wear and tear and technical obsolescence may be taken into account in settling the depreciation rates. Normally, salvage value need not be considered unless it can reasonably be expected to be substantial. Rates of depreciation under the declining balance method are twice the applicable straight-line rates. However, the declining-balance rate may in no case exceed 20 percent. Some typical lives and depreciation rates under the declining-balance method are as follows:

	Estimated life	Declining balance depreciation rate
Iron and steel industry:	*Years*	*Percent*
Blast furnace	10	20
Open hearth furnace	10	20
Electric furnace (for melting)	10	20
Automobile industry:		
Boring and turning mills	2-5	20
Radial drill	10	20
Steel forging hammers	10	20
Engine lathe (automatic)	6	20
Hydraulic press	8	20
Shearing machines	10	20
Textile industry:		
Carding machines	10	20
Combers	12	16
Dyeing machines (wood)	5	20
Dyeing machines (metal)	10	20
Looms (single)	12-15	13-16
Knitting machines	8-12	16-20

Industrial buildings, which may be depreciated only under the straight line method, typically have an estimated life of 50 years.

Types of buildings or equipment not subject to depreciation

None.

Accelerated depreciation

In addition to the acceleration provided by the use of the declining-balance method a number of special provisions are in effect. These special allowances are not applicable to the acquisition of used assets. Buildings, if two-thirds of the capacity is used for dwellings, may be depreciated 7½ percent in the year of completion and an equal amount in the following year. For the next 8 years, 4 percent per annum may be claimed. All investment in Berlin is eligible for special acceleration provisions. Movable assets may be depreciated up to 75 percent during the first 3 years if they will continue to be held in Berlin for an additional 3 years. Housing in Berlin may be depreciated up to

10 percent in each of the first 2 years and up to 3 percent in each of the following 10 years. Refugees and victims of Nazi persecution are granted an initial allowance of 10 percent of business construction costs in each of the first 2 years. Accelerated depreciation is also granted on a case-by-case basis for investments in certain eastern border areas. A special first year allowance of from 20 to 30 percent is permitted on certain imported items which are either subject to wide price fluctuation or are vital to the smooth functioning of the economy.

Farmers who keep books of account may depreciate movable assets up to 50 percent and fixed assets up to 30 percent during the first 2 years. These allowances are in addition to the normal depreciation during this period. However, the total depreciation may not exceed 50 percent of the gross income from agriculture or forestry. Other farmers may write off 25 percent of the cost of movable assets and 15 percent of the cost of fixed property in the year of acquisition. Improvements to buildings constructed before June 21, 1948, and with more than 50 percent of the capacity used for dwellings, may be written off up to 10 percent per annum during the first 10 years.

Private hospitals primarily serving low income groups may write off up to 50 percent of the cost of movable assets and up to 30 percent of the cost of fixed assets in the year of acquisition and the following year in addition to normal depreciation for these years. However, total depreciation may not exceed DM 100,000 (approximately $25,000) in a single year. Fifty percent of investments in movable assets and 30 percent for fixed properties used for the control of sewage and waste may be written off in the first 2 years. Movable assets for the control of air pollution may be depreciated up to 50 percent during the year of acquisition and the following year. Both of these allowances are in addition to depreciation otherwise allowable for these years.

Incentive allowances

None.

Adjustments for price level changes

Currently no adjustments for changes in the price level are allowed. However, taxpayers were permitted to revalue assets acquired prior to June 21, 1948, on the basis of replacement cost in August 1948. Subsequent depreciation is computed on the basis of such revaluation.

Treatment of gains on sale of depreciable property

Gains on the sale of depreciable property are taxed at ordinary rates except upon the sale of an entire plant. In such cases, special tax rates of from 10 to 30 percent are provided.

Treatment of losses on sale of depreciable property

Losses on the sale of depreciable property may be deducted in determining ordinary income except when an entire plant is sold in which case losses are only partially deductible.

Relationship of book and tax depreciation

Depreciation need not be recorded in the books of account to be deductible for tax purposes.

Provisions of prior law

The declining-balance method of depreciation was introduced in 1952 for all depreciable assets having a life expectancy of 10 years or more. The usual rates of depreciation were 3.5 times the straight-line rates. In 1956, the declining-balance method was limited to movable assets, but was allowed regardless of the expected life. At the same time, the rates were reduced to 2.5 times the straight-line rates with an absolute maximum of 25 percent. In 1960, the rates were further reduced to 2 times the straight-line rates with a maximum of 20 percent.

A number of incentives to investment through depreciation allowances have been available to taxpayers in Western Germany since 1948. Under all of these incentive provisions the total chargeoff was limited to the original cost of the asset. Generally, the incentive allowances in the early years of the life of the asset were in addition to the regular depreciation allowed for such years. For new assets acquired between January 1, 1949, and June 30, 1951, taxpayers could write off a total of 50 percent of the cost in the first 2 years up to an annual limit of DM100,000 (approximately $25,000). For ships acquired or constructed after January 1, 1949, and before June 11, 1958, a deduction of up to 15 percent

of the cost was allowed in each of the first 2 years. Under the investment assistance law of 1952, investment in coal, iron ore, iron, steel, and energy producing industries was encouraged by allowing a writeoff within the first 5 years of 50 percent of the cost of newly purchased equipment and 30 percent of the cost of buildings, provided these expenditures served immediately, directly, and exclusively to increase the output in these basic industries. This provision expired in 1960.

ITALY

Corporate tax rate

Because of the complexity and variations in the tax structure it is not possible to give a precise total rate for corporate income tax. In general, the maximum Central Government rate may be said to be approximately 40 percent.

Method of computing depreciation

Depreciation must be computed under the straight-line method.

Rates of depreciation

Although not having the force of law, Ministry of Finance tables of depreciation issued in 1957 are the standard base for maximum depreciation allowances. These rates are established, generally, for broad groups of items within a specific industry rather than for specific types of equipment. In exceptional cases of intensive production processes this maximum may be exceeded. Salvage value is not considered in the computation of depreciation. Some typical rates of depreciation are as follows:

	Percent
Iron and steel industry: Furnaces of any type	10
Rod and wire mill:	
Automatic	14
Nonautomatic	10
Metal products industries—machine tools:	
Automatic	8
Nonautomatic	12½
Textile industry (cotton, wool, and other natural fibers).	
Ordinary machinery and equipment	10
Machinery used in corrosive solutions	12½
Special equipment	25
Industrial buildings (of any construction and size, including plumbing, lighting, and heating):	
Agricultural buildings	3
Nonferrous metal fabricating buildings	4½

Types of buildings or equipment not subject to depreciation

None.

Accelerated depreciation

The normal period of depreciation of new plant and equipment and of expenditures for expansion, conversion, and reconstruction of existing plant and equipment may be reduced by not more than two-fifths. Thus, an asset which normally would be depreciated over 20 years at a 5 percent rate may be depreciated over 12 years at an 8⅓ percent rate. In addition, for the initial period and for each of the three succeeding periods an additional amount not exceeding 15 percent of the cost of the asset is added to normal depreciation.

Incentive allowances

None.

Adjustment for price level changes

At the present time, there is no general provision for adjusting depreciation to take account of changes in the price level. However, not later than 1953, taxpayers were permitted to revalue assets acquired prior to 1948 by coefficients reflecting the depreciation in the value of the currency. Such revalued amounts are used in computing subsequent depreciation.

Treatment of gains on sale of depreciable property

Gains on the sale of depreciable property are taxable as ordinary income.

Treatment of losses on sale of depreciable property

Losses on the sale of depreciable property are deductible from ordinary income.

Relationship of book and tax depreciation

In order to be deductible for tax purposes depreciation must have been recorded in the books of account.

Provisions of prior law

The present system of accelerated depreciation was originally adopted in 1951. In 1957, this system was temporarily superseded by a special deduction for 10 percent of the excess of expenditures for new plants over the depreciation for the year. The deduction was limited to 5 percent of income and was independent of and in addition to the depreciation otherwise allowable on the property. This special deduction was permitted for 1957, 1958, and 1959. In 1960, the original accelerated depreciation provisions were substituted for the special deduction.

JAPAN

Corporate tax rate

The maximum corporate tax on undistributed profits is 38 percent. The maximum rate on profits distributed as dividends is 28 percent.

Method of computing depreciation

Either the straight-line method or the declining-balance method may be used in computing depreciation. Generally, assets having a cost of 10,000 yen ($28) or less may be written off in the year of acquisition.

Rates of depreciation

Useful lives for various assets have been prescribed by the taxation authorities. Such lives must be used in computing depreciation unless permission is obtained for the use of shorter lives. Salvage value of 10 percent of the original cost is required to be set up for machinery and equipment. Declining-balance rates are applied to the original cost of the asset, while straight-line rates are applied to original cost reduced by salvage value.

The general formula for determining the declining-balance rate of depreciation is:

$$1-\sqrt[n]{.10}, \text{ where } n=\text{useful life.}$$

The following is a comparison of the straight-line rate and declining-balance rate for various useful lives:

[In percent]

Useful life	Straight-line rate	Declining-balance rate	Useful life	Straight-line rate	Declining-balance rate
2 years	50.0	68.4	15 years	6.7	14.3
3 years	33.3	53.6	20 years	5.0	10.9
5 years	20.0	36.9	25 years	4.0	8.9
8 years	12.5	25.0	40 years	2.5	5.6
10 years	10.0	20.6			

Some typical useful lives and depreciation rates under the straight-line and declining-balance methods are as follows:

Asset	Useful life	Rate: Straight line	Rate: Declining balance
	Years	*Percent*	*Percent*
Iron and steel industry:			
Blast furnace	17	5.8	12.7
Rod and wire mill	18	5.5	12.0
Open hearth furnace	18	5.5	12.0
Electric furnace	12-16	8.3-6.2	17.5-13.4
Metal products industry:			
Boring and turning mills	12-17	8.3-5.8	17.5-12.7
Radial drills	12	8.3	17.5
Wire drawing machines	12-13	8.3-7.6	17.5-16.2
Textile industry:			
Cording machines	11-13	9.0-7.6	18.9-16.2
Combers	13	7.6	16.2
Spinning frames	10-18	10.0-5.5	20.6-12.0
Dyeing machines	5-11	20.0-9.0	36.9-18.9
Looms	13-15	7.6-6.6	16.2-14.2
Knitting machines	13-17	7.6-5.8	16.2-12.7
Industrial buildings:			
Wooden buildings	8-20	12.5-5.0	25.0-10.9
Others	20-55	5.0-1.9	10.9- 4.1

Types of buildings or equipment not subject to depreciation

None.

Accelerated depreciation

Specified new equipment in major heavy and technical, mining, and refining industries, agricultural cooperatives, and experimental and research equipment is subject to a 33⅓ percent first-year depreciation allowance. This first-year allowance is in addition to the depreciation otherwise allowable in the first year on the equipment. The effect is to shorten the overall period of depreciation. The additional first-year depreciation may be claimed only to the extent that regular depreciation plus the first-year allowance does not exceed one-half of the corporation's taxable income prior to depreciation.

The following table shows the depreciation deductions for an asset qualifying for the first-year allowance and costing $1,000 with a useful life of 10 years under both the straightline and declining-balance depreciation.

Year	Straight line	Declining balance	Year	Straight line	Declining balance
1. First-year allowance (33⅓ percent of $1,000, less $100 salvage)	$300	$300	5	90	51
Regular allowance	90	206	6	90	40
	390	506	7	60	32
2	90	102	8		24
3	90	81	9		
4	90	64	10		
			Total	900	900

New houses which are built for rental and put into use between April 1, 1957, and March 31, 1962, may be depreciated at double the regular rate for the first 5 years.

Incentive allowances

None.

Adjustments for price level changes

The taxpayer is allowed to make adjustments in the depreciation base by applying a special price-level index prepared by the Bank of Japan. This index is revised when there are significant changes in the price level. The most recent revisions occurred in 1950 and 1953.

Treatment of gains on sale of depreciable property

Gains realized from the sale of depreciable assets are taxed at ordinary rates under the corporation income tax.

Treatment of losses on sale of depreciable property

Losses sustained on the sale of depreciable property are deductible in determining ordinary income.

Relationship of book and tax depreciation

Depreciation must have been recorded on the books in order to be deductible for tax purposes.

Provisions of prior law

Prior to April 1, 1961, several provisions for accelerated depreciation were in effect. Depreciation at 150 percent of the normal rate was allowed for each of the first 3 years on machinery and equipment designated by the Minister of Finance as necessary for the development of the Japanese economy or for the modernization of cooperative business activities. Depreciation of 50 percent was allowed in the first year on machinery and equipment designated by the Minister of Finance as necessary for the modernization of important industries or for use in developing new manufacturing processes. Fifty percent of the cost of machinery and equipment approved by the Minister of Finance for use in experimentation and research could be deducted in the first year, and 20 percent could be deducted in each of the second and third years. In general, these provisions were consolidated into one system of 33⅓ percent first-year depreciation allowances as of April 1, 1961.

NETHERLANDS

Corporate tax rate

For an annual taxable profit under f40,000, the tax rate is 44 percent. For f40,000 to f50,000 the rate is 44 percent plus a 15-percent surtax on the amount over f40,000. Any taxable profit above f50,000 has a 47-percent tax rate applied to it. The above rates will be replaced once the Dutch Government issues a decree implementing a law passed by Parliament which reverts rates back to the previous 40 and 43 percent, respectively. In addition, the new law provides that the tax rate on distributed profits shall be 15 percentage points under the rate for undistributed profits. The decree has not as yet been issued.

Method of computing depreciation

Taxpayers may use either a straight-line or diminishing-balance method of depreciation. There is no restriction on the method used according to the type of asset acquired. Low-value items forming a customary part of initial or production expenses may be written off at the entire cost in the year of acquisition under the "De Minimis Rule."

Rates of depreciation

The basis for depreciation is historical cost, not replacement value. Depreciation rates are determined through negotiations between tax authorities and taxpayer. Where useful life of the asset is shorter than the physical life, because, for example, of technological obsolescence, the taxpayer may use this in determining depreciation rates. Salvage value is taken into consideration; the taxpayer is only allowed to depreciate the difference between historical cost of the asset and its salvage value. Rates under either the straight-line or declining-balance method must result in depreciation to salvage value at the end of the useful life of the asset. Conventional rates are stated to be 10 percent for machinery and 1½ to 3 percent for buildings per year. The general formula for the declining-balance method is:

$$d = \left(1 - \sqrt[n]{\frac{s}{c}}\right)$$

with d = Annual depreciation rate
s = Salvage value
n = Life of asset in years
c = Historical cost

The rate per year has no specified limitation, but the taxpayer must remain within the limits of good commercial practices. The Netherlands allows depreciation to begin when the asset is "contracted for." To stop abuse through excessively long production delays, a bill is now pending before Parliament which would restrict depreciation to the portion of the asset already paid for.

Types of buildings or equipment not subject to depreciation

None.

Accelerated depreciation

Due to a labor shortage, assets purchased after April 29, 1960, can now only have one-third of their total cost written off by accelerated depreciation at a lower rate and over a longer time than previously. Under this new formula, 8⅓ percent of investment per year in machinery and equipment may be written off the first 4 years, and 6 percent for the first 5½ years of buildings; that is, the total accelerated depreciation, 33⅓ percent of cost, is taken at 6 percent per year for 5 years, leaving 3⅓ percent for the sixth year. The final two-thirds cost may be written off over the entire life of the asset in the regular manner. An exception is the 16⅔ percent per year accelerated writeoff allowed for investments by shipping and air transport companies engaged in international traffic. The accelerated provisions are not now applicable to office equipment and motor cars not used primarily for commercial road transport. The accelerated depreciation in respect of an asset need not be applied in the first year in which this is permitted, but if it is applied in a subsequent year the normal depreciation previously applied must be taken into account. Accelerated depreciation applies to used as well as to new property in the Netherlands.

Incentive allowance

A special investment allowance is given which allows individual or corporate taxpayers to deduct a percentage of new investment from taxable profits. The allowance has no connection whatsoever with depreciation. Eligible investment can be acquisition of new or used assets or improvement of already owned assets, but the amount of investment must exceed 3,000 florins (approximately $800) during the tax year concerned. Investment must be in business assets to qualify for the allowance, land and residential property being ineligible. For such assets for which orders were placed after April 29, 1960, the allowance is 5 percent of cost in each of the first 2 years. In effect, this means that 110 percent cost can be recovered by the investor. If the assets are sold within 10 years, the taxpayer must add back to income in the 2 years following disposition the amount of the allowance.

Adjustments for price level changes

The taxpayer may not make adjustment in the amount of depreciation on the basis of price fluctuations. However, if substantial changes occur in the salvage value of the assets, appropriate adjustment may be allowed by the authorities.

Treatment of gains on sale of depreciable property

All gains from the sale of assets are treated as ordinary income.

Treatment of losses on sale of depreciable property

Losses resulting from sales of asset mays be deducted from profits.

Relationship of book and tax depreciation

Fiscal treatment of depreciation is independent of treatment in books of account.

Provisions of prior law

When the loss of Indonesia forced the Netherlands to emphasize increased industrialization of the homeland, substantial initial allowances for depreciation of plant were granted. Accelerated depreciation was first introduced for assets ordered after December 31, 1949. The period over which the one-third of the cost could be depreciated has been changed frequently. For example, in 1950 and 1951, all of the one-third of the cost of buildings could be written off in 1 year. For buildings, other than new factory buildings, the period was extended to 3⅓ years in 1953. This same period became effective for new factory buildings after November 1, 1955. For 1959 the period for new factory buildings was changed to 2 years. Similarly, different rates have been in effect for automobiles, office furniture and fixtures, intangible assets, and other machinery. A more specific

summary of some of the provisions making different accelerated depreciation methods permissible is as follows:

A—The total permissible amount may be written off at once;
B—The annual amount is limited to 10 percent of cost;
C—In 1952 for certain assets accelerated depreciation was limited to 10 percent of cost; after that year the limitation was withdrawn.
D—In the first year the amount is limited to 16⅔ percent of cost.

These possibilities may be applied to various classes of assets as follows:

Class of assets	Period in which ordered or acquired.*	Possibility
Buildings:		
All buildings	1950-1951	A
	1952-Oct. 31, 1955	A
New factory buildings extending production capacity	Nov. 1, 1955-1958	B
New factory buildings	1959-Apr. 29, 1960	D
Other buildings	1952-Apr. 29, 1960	B
Automobiles:		
All automobiles	1950-1951	A
All automobiles operated by a transport enterprise	1952-Oct. 31, 1955	A
	Nov. 1, 1955-1958	B
	1959-Apr. 29, 1960	D
Automobiles not operated by a transport enterprise:		
Passenger cars	1952-Apr. 29, 1960	B
Lorries, vans, etc	1952-1958	B
	1959-Apr. 29, 1960	D
Office furniture and fixtures	1950-1951	A
	1952-Apr. 29, 1960	
Intangibles	1950-1951	A
	1952	C
	1953-Oct. 31, 1955	A
	Nov. 1, 1955-1958	B
	1959-Apr. 29, 1960	D
Other assets	1950-Oct. 31, 1955	A
	Nov. 1, 1955-1958	B
	1959-Apr. 29, 1960	D
Other assets ordered in 1950-1952 and not paid for at Dec. 31, 1952.		C

*Possibility D applicable only if the asset is ordered and acquired after Jan. 1, 1959. For an asset ordered in 1958 and acquired in 1959 possiblity B remains applicable.

The special incentive allowance on investment was introduced in 1953 and several changes have been made in the rates and time of deducting the allowance. The following table summarizes these changes:

Period in which commitments were entered into or self-made assets were manufactured	Investment deduction		Disinvestment additions when sold within 10 years	
	Number of years	Percentage per annum	Number of years	Percentage per annum
Apr. 1, 1953, to Nov. 5, 1956	5	4	[1] 5	[1] 4
Nov. 6, 1956, to May 20, 1958 (except for certain ships and aircraft; see below)				
May 21, 1958, to Dec. 31, 1958 (except for certain ships and aircraft; see below)	4	4	4	4
Calendar year 1958. Only for ships and aircraft to be used mainly for international traffic	5	4	5	4
As from 1959 to Apr. 29, 1960	2	8	2	8

[1] No addition when sold in the period Nov. 6, 1956, to Dec. 31, 1958.

SWEDEN

Corporate tax rate

The national corporate tax rate is 40 percent.

Method of computing depreciation

Two alternative methods of computing depreciation on machinery and equipment are available. The "book depreciation" method, used by most taxpayers, permits the deduction of whatever depreciation the taxpayer chooses to take on its books, provided the deduction does not exceed the higher of two alternative

limitations. One of the alternative limitations is the amount computed by applying a 30-percent rate under the declining balance method for all machinery and equipment. The other alternative limitation is the amount necessary to reduce the book value of all machinery and equipment to a figure equal to (1) its total acquisition cost reduced by (2) depreciation at the rate of 20 percent, on a straight-line basis, since acquisition. In effect, the taxpayer may write off the entire cost of machinery and equipment in 5 years. The "planned depreciation" method allows taxpayers to write off the cost of machinery and equipment, on the straight-line method, over the estimated useful life.

Equipment having a useful life of 3 years or less may be written off in full in the year of acquisition.

Buildings must be depreciated on the straight-line method over the estimated useful life.

Rates of depreciation

Under the "book depreciation" method described above machinery and equipment may be depreciated at any rate desired by the taxpayer, subject to the limitation. Effectively, this method allows the writeoff of machinery and equipment over a 5-year period.

Rates of depreciation for buildings are, generally, between 1½ and 3 percent under the straight-line method.

Types of buildings or equipment not subject to depreciation

None.

Accelerated depreciation

Except for the acceleration provided by the "book depreciation" method of depreciation for machinery and equipment, no special accelerated depreciation allowances are in effect.

Incentive allowances

No direct incentive allowances are made. However, the operation of the investment reserves for economic stabilization may, in effect, permit the taxpayer either accelerated depreciation or an incentive allowance. Corporations are permitted to set aside up to 40 percent of their pretax business income as an investment reserve for economic stabilization. Amounts allocated to the investment reserve are deductible for tax purposes. Forty-six percent of the amount so allocated must be deposited with the Bank of Sweden, the other 54 percent remaining as part of the working capital of the corporation. The control of the use of the reserve is vested in the labor market board. The board may authorize a corporation to use all or part of its investment reserve whenever the economic and employment situation so warrants. Under the law, the board may even direct a corporation to use all or part of its investment reserve. The purposes for which the reserve may be used include the construction of buildings, the acquisition of new machinery and equipment, the purchase of inventory, and the development of mineral deposits.

When an investment reserve is used with the permission of the governmental agency, the amount so used is not restored to taxable income. However, the basis of assets acquired by use of the reserve must be reduced correspondingly. A corporation using an investment reserve with the permission of the labor market board receives a special additional "investment deduction" of 10 percent of the amount of the reserve so used. If a reserve is used without permission of the board, the amount of the reserve plus a penalty of 10 percent must be added to taxable income. However, after 5 years, the corporation may withdraw up to 30 percent of the reserve without government permission without incurring the 10-percent penalty.

Adjustments for price level changes

None.

Treatment of gains on sale of depreciable property

Gains on the sale of machinery and equipment are not taxable as such under the book depreciation method. However, any proceeds of sale reduce the basis for depreciation of other machinery and equipment. However, gains on the sale of buildings are considered capital gains. Capital gains are taxed on a sliding scale so that no tax is levied if the buildings have been held 10 years or more.

Treatment of losses on sale of depreciable property

Losses on the sale of machinery and equipment are not deductible as such on the book depreciation method. The proceeds of sale are credited to the basis of the entire stock of machinery and equipment and thus, any loss is deductible in the form of future depreciation allowances. Losses on the sale of buildings are considered capital losses which are deductible only to the extent of capital gains.

Relationship of book and tax depreciation

Depreciation on machinery and equipment under the book depreciation method must be recorded in the books of account in order to be deductible for tax purposes. Other depreciation may be deducted even though it is not recorded on the books.

Provisions of prior law

Beginning in 1938, taxpayers were allowed, under the book depreciation method to writeoff the cost of machinery and equipment in the year of acquisition or to depreciate the cost in any manner chosen by the taxpayer. The present limitations on the amount which may be written off in any 1 year became effective in 1956.

A temporary tax on certain capital expenditures, the investment tax, was in effect in 1952 and 1953, lifted for 1954, and in effect again in 1955, 1956, and 1957. The tax applied to the total of the taxpayer's taxable investment in excess of an annual exemption. The rate was 12 percent for 1957, but since the tax was deductible for ordinary income tax purposes, the effective rate was somewhat lower. This tax was levied as an anti-inflation measure.

UNITED KINGDOM

Corporate tax rate

The maximum corporate tax rate is 53¾ percent.

Method of computing depreciation

Depreciation of plant and machinery may be computed under either the declining-balance or the straight-line method. The declining-balance method is most commonly used. Industrial buildings and structures are required to be depreciated on the straight-line method.

Rates of depreciation

The rates of depreciation for machinery and equipment are determined by the Commissioners of Inland Revenue and a list of basic rates is published. However, the taxpayer may apply for an increase in these rates. The basic rate under the straight-line method assumes a residual salvage value of 10 percent. Therefore, the formula for the straight-line rate is

$$\frac{.9}{\text{anticipated normal working life}}$$

The formula for the declining balance rate is $1-\sqrt[n]{.10}$, where n= anticipated normal working life. The basic rates as determined above are multiplied by 5/4 to obtain the rate actually used in computing the depreciation deduction. The rates of depreciation for certain machinery and equipment are as follows:

	Declining-balance	Straight-line
	Percent	*Percent*
Iron and steel manufacturing machinery and plant	9	3.75
Manufacture of motor vehicles:		
High speed precision plant	15	6.6
Steam engines, boilers and shafting	6	2.5
Other manufacturing machinery	9	3.75
Cotton spinning and manufacture:		
Motive power machinery	6	2.5
Process machinery	9	3.75

Industrial buildings and structures which are new in the hands of the taxpayer are subject to a 2-percent straight-line rate. Buildings which are used when acquired by the taxpayer are depreciated on a straight-line rate determined by the following formula:

$$\frac{1}{50-\text{number of years since construction of building}}$$

In no case, may depreciation be claimed for any period more than 50 years after the date of construction of a building. Also, in general, a purchaser of a used building may not depreciate any portion of his cost which is in excess of the original construction cost of the building.

Types of buildings or equipment not subject to depreciation

Depreciation is not permitted on structures used as dwellings, retail shops, showrooms, hotels, and offices.

Accelerated depreciation

Besides the acceleration provided by the use of the declining-balance method for plant and machinery, a system of first-year allowances is in effect. These initial allowances are in addition to the regular depreciation allowed in the first year. However, the initial allowances reduce the basis of the asset for purposes of the computation of subsequent years' depreciation under the declining-balance method. The current rates of initial allowance are:

	Percent
New assets:	
Industrial buildings and structures	5
Mining works	20
Automobiles	30
Agricultural buildings	0
Scientific research assets	0
Ships	0
Other plant and machinery	10
Used assets, including ships and cars	30

Assets used for scientific research may be depreciated 60 percent in the first year and then 10 percent for 4 years. Agricultural and forestry buildings may be depreciated at a 10-percent rate for 10 years.

Incentive allowances

An investment allowance is permitted on the acquisition of many types of new depreciable property. At the present time, both the allowance and the additional first-year depreciation may be claimed on the same property. Rates of allowances are:

	Percent
Industrial buildings and structures	10
Agricultural works	10
Mining works	20
Scientific research assets	20
Ships	40
Cars	0
Other plant and machinery	20

The following table gives the deductions allowable with respect to a $1,000 new asset, having a 10-year life and qualifying for a 10-percent first-year depreciation and a 20-percent incentive allowance. The regular rate of depreciation for such an asset is 25 percent under the declining-balance method and 11 percent under the straight-line method.

Year	Declining-balance method	Straight-line method	Year	Declining-balance method	Straight-line method
1. Regular depreciation	$250	$110	4	$91	$110
First-year depreciation	100	100	5	68	110
Investment allowance	200	200	6	52	110
	550	410	7	38	110
2	163	110	8	29	110
3	122	110	9	22	20
			10	[1] 65	0
				1,200	1,200

[1] Remaining undepreciated cost of asset.

Adjustments for price level changes

None.

Treatment of gains on sale of depreciable property

Gains on the sale of depreciable property are taxable as ordinary income to the extent of depreciation previously allowed with respect to the property. Any gain in excess of this amount is nontaxable as a capital gain. A taxpayer may elect, in the case of plant or machinery, instead of paying the tax on the gain to reduce correspondingly the basis of the replacement property for purposes of computing the initial depreciation and regular depreciation. However, the election does not decrease the investment allowance on the new asset.

Treatment of losses on sale of depreciable property

Losses on the sale of depreciable property are allowable as deductions in computing ordinary income.

Relationship of book and tax depreciation

Depreciation need not be recorded in the books of account to be deductible for tax purposes.

Provisions of prior law

The system of first-year allowances was introduced in 1946. The rates of allowances have been changed frequently since that time, the present rates being effective for expenditures made after April 7, 1959. Some of the general rates that have been in effect are as follows:

[In percent]

	Machinery and equipment	Industrial buildings
Apr. 6, 1946, to Apr. 5, 1949	20	10
Apr. 6, 1949, to Apr. 5, 1952	40	10
Apr. 6, 1952, to Apr. 14, 1953	0	0
Apr. 15, 1953, to Apr. 14, 1958	20	10
Apr. 15, 1958, to Apr. 7, 1959	30	15

Investment allowances were first introduced in 1954 and several changes in rates have been made. Up until April 7, 1959, taxpayers could not claim both an investment allowance and first-year depreciation on the same asset. However, for assets acquired after that both allowances may be claimed. Prior general rates of investment allowances have been:

[In percent]

	Machinery and equipment	Industrial buildings
Apr. 6, 1954, to Feb. 17, 1956	20	20
Feb. 18, 1956, to Apr. 7, 1959	0	0

Source: Treasury Department, Office of Tax Analysis.

Senator WILLIAMS. Is it not a fact that in addition to the depreciation schedules, many of those countries have much lower rates of corporate taxes?

Secretary DILLON. That is true, also; but, certainly, many of them have rather high taxes.

Great Britain has 53.5 percent; France and Germany have approximately 50 percent; Holland has about 47 percent. The two in Europe that have really lower rates are Belgium and Italy, which are just over 30 percent.

Senator WILLIAMS. Now, the report which I have here lists Germany at 51 percent, but the German corporate rate of 51 percent is reduced to approximately 22 percent if all the profits are distributed. So there is quite a difference there, is there not?

Secretary DILLON. That is correct.

Senator WILLIAMS. And I notice that Australia has 40 percent. That is what is listed on this report which was furnished to me.

Secretary DILLON. Having 40 percent in Australia? I assume that is right.

Senator WILLIAMS. And Belgium they list at 28.5 percent.

Secretary DILLON. That is right.

Senator WILLIAMS. They say that Belgium has a 40-percent rate, but they get the credit on the following year for the Federal taxes which they paid in the preceding year?

Secretary DILLON. Yes; which, in effect, makes it 28.5 percent.

Senator WILLIAMS. That is right.

Now, since you are going on a general adjustment basis, have you given any consideration to changing our corporate rates?

Secretary DILLON. No. We are recommending, though, that the deferral of U.S. tax be eliminated, in another section of this bill.

Senator WILLIAMS. I am not speaking of that section.

Secretary DILLON. That would equalize this.

Senator WILLIAMS. I am speaking about the domestic corporation rates here in America.

Secretary DILLON. Not at this time; no.

Senator WILLIAMS. With the exception of England, we are the highest that I see on this list of any of the countries, is that correct?

Secretary DILLON. No. At the moment Canada is imposing a tax of 57.5 percent on American investment in Canada.

Senator WILLIAMS. On American investment; but how about on Canadian investment?

Secretary DILLON. 50 percent.

Senator WILLIAMS. 50 percent.

I am speaking about the manner in which these countries tax their own business.

We tax American industry here higher than industry is taxed in any other country, except England; is that not true?

Secretary DILLON. Slightly higher.

Senator WILLIAMS. Slightly higher.

Well, it is substantially higher in some of these instances.

Secretary DILLON. In some instances, but slightly higher in many, and, certainly, when we have our general reform proposals on the income tax rate structure, that will be one subject that we would feel should be looked at, at that time.

Senator WILLIAMS. Mr. Chairman, I would like to ask that this table showing the corporate rates of these respective countries be incorporated in the record at this point. It clearly shows that when you change this investment credit, even with it you are only beginning to touch the problem, if you are trying to equalize the tax rate of American industry as compared with competitors in foreign countries.

The CHAIRMAN. Without objection.

(The table referred to is as follows:)

Comparison of maximum rates of corporate income taxes in selected countries

Country	Rate (percent)	Country	Rate (percent)
Australia	40	Italy	31
Belgium	28.5	Japan	49
Canada	50	Luxembourg	42
Denmark	44	The Netherlands	47
France	50	Sweden	40
West Germany	51	United Kingdom	53.5

NOTE.—See exhibit III, table 2, for details and qualifying footnotes.

Secretary DILLON. That is as compared to a foreign competitor, because, with the deferral, we will equalize it with American competitors if we do away with deferral.

Senator WILLIAMS. Will this investment credit be granted in either the procurement of equipment for a plant or the construction of a plant?

Secretary DILLON. This is simply for machinery and equipment that go into a plant. It is not for the building itself.

Senator WILLIAMS. Just machinery?

Secretary DILLON. Just machinery and equipment; but there is a detailed definition in the House bill of what is machinery and equipment, and it is rather broader than the usual descriptions.

In other words, such things as a blast furnace we consider machinery and equipment, rather than real estate.

Senator WILLIAMS. Does this include trucks?

Secretary DILLON. Trucks would be included partially, because, under the provision of the House bill, there is a sliding scale whereby equipment that has a life of 4 to 6 years gets one-third of the credit. Equipment with a life of 6 to 8 years gets two-thirds, and over 8 years gets the full credit.

Now, trucks and automotive equipment would generally, probably, qualify for the one-third credit or, possibly, if they were used longer, for two-thirds, but no more than that.

Senator WILLIAMS. Does it include the equipment for a general store, a small businessman?

Secretary DILLON. That is correct.

It includes all equipment of any kind.

Senator WILLIAMS. Does it include the equipment which an American corporation may buy, even though he buys that equipment from Germany or Japan?

Secretary DILLON. Yes, it does.

Senator WILLIAMS. Would that help the American labor situation by giving him further investment credit? That would be the equivalent of a 16 percent reduction, would it not, on the cost of this imported machinery?

Secretary DILLON. It would not change the situation that exists today in this regard, because the reduction would apply, irrespective of where they bought the machinery, and it would serve the purpose of making them more competitive, so their product could be more competitive with foreign products.

Senator WILLIAMS. But it still would be, in effect, a 16 percent reduction or subsidy on the cost of buying this machinery from abroad, would it not?

Secretary DILLON. An 8 percent reduction on buying it anywhere, including abroad.

Senator WILLIAMS. Do you think that the accelerated rate of depreciation, if we change that to 2.5 times or 3 times instead of double, would not, in effect, do the same job and be simpler, whereby all taxpayers could understand the formula?

Secretary DILLON. I think they will learn to understand the credit formula very easily, once it is in effect. We do have figures—I think we furnished them to you, Senator—on the triple declining balance depreciation, and this would increase the rate of return on a 10-year asset from 5.6 percent at present to 6.4 percent, as compared to 7.9 for the investment credit.

When you go to a 15-year asset, it would increase the 5.6 percent to 6.3, as compared to 7.3 for the investment credit.

And for a 20-year asset, which is about as long as any machinery and equipment would last, it would increase the profitability to 6.2, compared to 6.9 percent for the investment credit.

So, therefore, it has less of an impact, and, as far as its cost is concerned, it is considerably greater.

The cost for the first 5 years would be $8.3 billion for the investment credit and nearly $12 billion for triple declining balance; and on the basis of 10 years, it would be about $30 billion for triple declining balance and $22.6 billion, which is the figure Mr. Stam used, for the investment credit.

So the triple declining balance would cost us very considerably more money and do less good in the way of an incentive for investment.

Senator WILLIAMS. Mr. Secretary, we are both aware of the fact that we can prove practically anything with figures. Now, let us take a different period.

You have used the 5-year period on a 15-year-life machinery?

Secretary DILLON. Yes.

Senator WILLIAMS. Is it not a fact that, figuring on the full life of the machine that is being bought or the equipment that is being bought, whether it be a 5-year period, 10-year period, or 20-year period, would not the triple balance method cost the Treasury less revenue than the one you are putting in here now; and if it does not, tell me how?

Secretary DILLON. No, it would cost substantially more, Senator.

Senator WILLIAMS. Now, may I ask you this question.

If you can give 116 percent writeoff on the one instance, 116 percent of the total cost, say that was a 20-year period.

Secretary DILLON. That is right.

Senator WILLIAMS. Under the triple declining balance they would only write off 100 percent, is that correct?

Secretary DILLON. That is right.

Senator WILLIAMS. And yet you say you can write off 116 percent and it will cost the Government less than allowing them 100 percent?

Secretary DILLON. That is right.

Senator WILLIAMS. I ask you this question. Let us double that and write off 40 percent and then you will make money. Are you trying to tell me that you can allow a taxpayer to write off 116 percent of the cost of the investment and it will cost less in revenue to the Government than it would if you let him write off 100 percent?

Secretary DILLON. That is absolutely correct and it is shown very clearly here in exhibit 1-A.

Senator WILLIAMS. I have read your exhibits; I must disagree with you. You only show such results by picking the period half or a third of the way through.

If you follow it through to the ultimate end, your formula does cost more money.

I can only say, with all due respect—and I have got great respect for you—I am beginning to understand where we get our bad deficits guesses. I get back to my question again——

Secretary DILLON. I would say this, Senator:

That the investment credit, compared to triple declining balance depreciation, will catch up in cumulative cost and will cost more than triple declining balance at some time 20 to 30 years from now, depending upon the rate of growth of investment—the higher the rate of growth the longer it will take the cost of the investment credit to catch up.

For the first time up until then, it will cost less.

Senator WILLIAMS. It will cost more when you reach the end of the life of the equipment to which you are figuring?

Secretary DILLON. Oh, no, no; it is much longer than that.

Senator WILLIAMS. Well, it is very close to it?

Secretary DILLON. No.

It depends——

Senator WILLIAMS. Well, when you pass the life of it, you are passing 100 percent, and I get back to my question again. If you are correct, and the 16 percent extra allowance does bring in more money to the Government, why did you not double it? Why be so conservative?

Secretary DILLON. We have to look at the economy as it functions, Senator, and, as it functions and as we hope it will—it will be calamitous if it does not—the United States is going to continue to grow and we are going to spend more money on plant and equipment as the years go along, as our economy grows. And that factor has to be taken into account.

And on that basis that will increase the cost and stretch out the time for which these various other methods of extra depreciation will cost more in total than the investment credit, and they will be stretched out to somewhere like 20, 25, 30 years under any basis of figures that you want.

If you give us any particular proposal which you want, we would be glad to work out the figures for you and give you the answer.

We are not attempting to figure this on any particular special, favorable basis, because the answer is clear that if we allow triple declining depreciation, there is no other subsidy in there. It is just the same as the subsidy from any other kind of method which depreciates more rapidly than a realistic depreciation, and, actually, it will cost more for any reasonably foreseeable future time.

Senator WILLIAMS. All right, just take a piece of equipment that costs $100,000.

The life of it is 15 years, and just say, for instance, you use the triple declining balance method.

Now, I am not saying you can afford to do that. Maybe it should be 2½, but just use the triple. At the end of that 15-year period under the triple-declining balance method how much would you have written off; $100,000 cost for one piece of equipment?

Secretary DILLON. Quite correct, Senator, when you talk about one piece of equipment.

Senator WILLIAMS. That is what I am talking about.

Secretary DILLON. That is not what a company does, as it lives. That is not what the United States Government has to do in figuring its revenue.

Senator WILLIAMS. I am not saying that in both instances you could not depreciate this $100,000, then buy more if you wanted to. I am not speaking about that. I am speaking about buying one piece of equipment at $100,000, with 15-year life. At the end of 15 years, you have written off how much?

Secretary DILLON. If you have triple declining, double declining, or quadruple declining, you write off the entire cost.

Senator WILLIAMS. And under this bill which you are recommending, you would write off $116,000, is that correct?

Secretary DILLON. $116,000, that is correct, on one piece.

Senator WILLIAMS. Yes, you say that would cost less than it would if you allow only $100,000?

Secretary DILLON. It would cost less to the Government over a period of time. You do not write off on one piece of machinery. You buy lots of pieces of machinery every year and you buy more and more equipment. You do not wait until that machine gets finished. At the end of that 15 years you replace it, with what may be still more expensive equipment, and then the extra benefit from the accelerated depreciation comes in again.

Senator WILLIAMS. But that happens under either of the examples which we cited.

Secretary DILLON. Yes.

Senator WILLIAMS. And you write the other one off with triple——

Secretary DILLON. In the early stages, the triple declining costs more to the Government than investment credit.

Senator WILLIAMS. Less in the latter part?

Secretary DILLON. Less in the latter part for any particular asset. But in the latter part you buy some more equipment, and, therefore, the total, when you put it up all together, costs more because of the accelerated depreciation on the replacement of additional equipment.

Senator WILLIAMS. But it would cost more under the triple only because you were getting more expansion in America?

Secretary DILLON. Well, or under the investment credit, both of them, you are getting more expansion.

Senator WILLIAMS. But if you have got the same expansion under both cases, it would cost more under the investment credit?

Secretary DILLON. No, it would not.

Senator WILLIAMS. I have no hope of ever balancing the budget if this is a sample of your estimates.

Secretary DILLON. I am sorry.

Senator WILLIAMS. I just do not follow your line of reasoning.

Secretary DILLON. If you will look carefully and study these exhibits——

Senator WILLIAMS. I have studied your exhibits. They have been down here.

I have studied them.

I will be honest with you, I just cannot follow your reasoning.

Secretary DILLON. We will be glad to try and explain it to you.

Senator WILLIAMS. I know you cannot write off 116 percent and say it will cost less than if you write off 90 or 100 percent.

Secretary DILLON. It just happens that our economy is growing and moving and not a static one, and I certainly have every hope and expectation it will stay that way, so the accelerated depreciation is a more complicated formula, when you apply it to a growing economy, a booming economy, than when you apply it to one single piece of equipment.

Senator WILLIAMS. Just this one thought:

We were discussing the British corporate rate as being higher than ours. I have just been furnished a memorandum. Perhaps you can comment on it. The British rate of 53 percent corporate rate is reduced by the payment of dividends, whereas our rate is not.

That being true, they get a credit for a payment of dividends?

Secretary DILLON. There is a credit allowed to the recipient of the dividend.

Senator WILLIAMS. Would you furnish for our committee a list of the top 10 industries, and the approximate estimate of the benefit that would accrue to those industries under this bill as we have it before us today?

Secretary DILLON. Yes, with a note attached that we desire and are recommending strongly that the public utilities be removed from this bill. They are certainly one of the biggest industries.

Senator WILLIAMS. Will you furnish the information for the bill as reported, passed by the House?

Secretary DILLON. Yes.

Senator WILLIAMS. And also a list showing what the benefits would be under your recommendation?

Secretary DILLON. I will be very glad to do that, yes.

(The following was later received for the record:)

Comparison of industry distribution of benefits under investment credit plans and 300 percent declining balance depreciation

[Dollar amounts in millions]

	1959 corporate tax liabilities	Ways and Means Committee credit		Treasury recommended credit		300 percent declining balance depreciation	
		Amount	Percent	Amount	Percent	Amount	Percent[1]
Agriculture		$80	6.8	$100	7.4	$90	9.0
Manufacturing	$12,433	450	38.3	660	48.9	500	50.0
Iron and steel		60	5.1	100	7.4	75	7.5
Machinery, except electrical		35	3.0	45	3.3	35	3.5
Motor vehicles		35	3.0	50	3.7	40	4.0
Food and beverages		30	2.6	40	3.0	30	3.0
Chemicals		50	4.3	75	5.6	60	6.0
Petroleum and coal		90	7.7	150	11.1	110	11.0
All other manufacturing		150	12.8	200	14.8	150	15.0
Mining	473	35	3.0	50	3.7	40	4.0
Railroads	684	25	2.1	40	3.0	30	3.0
Other transportation		60	5.1	100	7.4	75	7.5
Public utilities	1,440	130	11.1				
Communications	1,374	95	8.1				
Commercial and other		300	25.5	400	29.6	265	26.5
Total, 1962		1,175	100.0	[2] 1,350	100.0	[3] 1,000	100.0
Total, 5th year[4]		1,430		1,640		3,000	
Total, 10th year[4]		1,825		2,095		2,600	

[1] Industry distribution would be similar for any method of accelerating depreciation involving the same coverage.
[2] Full year after all provisions are in effect.
[3] Comparable in coverage to the Treasury recommended credit; assumes all new qualifying investment is depreciated by 300 percent declining balance method.
[4] Assuming 5 percent growth rate.

NOTE.—The estimated amount and distribution of benefits under the investment credit and 300 percent declining balance depreciation are based on Commerce-S.E.O. survey data projected 1962 investment expenditures. The distribution in future years will depend upon the nature and extent of structural changes in the economy. For comparison of the profitability effects of the investment credit and 300 percent declining balance depreciation, see exhibit I, table 1.

The corporate tax liabilities given in column 1 are presented only for those industries in which corporations are predominant. Although precise estimates are impossible to make, in general industry distributions of investment credits or depreciation acceleration follow the pattern of tax liabilities.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

Senator WILLIAMS. I understand that certain features of this bill are designed to plug loopholes in our tax laws. I might say on that point I am in agreement with your objective, but is that one of the main objectives of those sections of the bill, to plug loopholes, and, thereby, provide some additional revenue to offset this billion and a half?

Secretary DILLON. That is correct. A great many of the sections are for that purpose, practically all of the rest of the bill; yes. It is either loopholes or inequities.

Senator WILLIAMS. All right.

Secretary DILLON. I do not know whether you call it a loophole when you start taxing mutual savings banks. It is just an inequity in the law. I would not call it a loophole.

Senator WILLIAMS. I, for several years, have been interested in correction of the depletion allowance for oil and gas. I notice that you did not refer to that in this bill.

Was that intentional. Do you consider the depletion allowance as a potential loophole needing changing, or do you think it is all right as it is?

Secretary DILLON. That was intentional. We stated, I think very clearly, last year that when we came up with our overall income tax proposals for reforms to the individual rates, that we would look at a whole lot of propositions for broadening the base, and we specifically stated that the depletion allowance would be one of them. That is one of the things we will be looking at. Our studies have been progressing but they are not yet complete.

Senator WILLIAMS. I would like to read an excerpt from former President Truman from a message that he sent to the Congress on January 23, 1950. We have been studying this ever since.

Senator KERR. Will the Senator yield?

Senator WILLIAMS. Sure.

Senator KERR. I think it is wonderful that the Senator from Delaware is making a study of such a very high-class source.

Senator WILLIAMS. I always refer to these very high-class statements, I quote from President Truman's message:

> I know of no loophole in the tax laws so inequitable as the depletion exemptions now enjoyed by the oil and mining industries.

He goes on and he says:

> For example, during the 5 years 1943–47, during which it was necessary to collect an income tax from people earning less than $20 a week, one oil operator was able, because of these loopholes, to develop properties yielding nearly $5 million in a single year, without payment of any income tax.
>
> In addition to escaping the payment of tax on his large income from oil operations, he was also able, through the use of his oil tax exemptions, to escape payment of tax on most of the incomes from other sources.
>
> For the 5 years his income taxes totaled less than $100,000, although his income from oil sources along averaged almost $1 million each year.

Well, I will continue reading:

> This is a shocking example of how present tax loopholes permit a few to gain enormous wealth without paying their fair share of taxes.

Do you think that the example President Truman cited in 1950 was accurate?

Secretary DILLON. I have no way of knowing. I assume if the President cited it, it must have been an accurate example. But I have not studied it myself.

Senator WILLIAMS. Assuming its accuracy—and I have not as yet seen it challenged—do you not think that that is one loophole we should have directed a little bit of attention to, or was there any specific reason why that was exempted?

Secretary DILLON. The only reason was that we were going to make these recommendations. We had to make them on things that we had our study completed on.

We were prepared to move ahead on these last April a year ago, and those were the recommendations made at that time by the President and that is the bill that we still have before us. At that time the President stated there would be a further bill when this was finished, which would try to broaden the tax base and allow readjustment of the income tax rate schedules.

That is very much on our minds, and we are looking at all sorts of other matters and inequities.

We make no pretense that this bill handles them all. There are lots of them.

And one of the things that will be looked at and will be included with a recommendation one way or another are the depletion allowances, not just for oil but for everything.

Senator WILLIAMS. I just mentioned oil. I agree they do all deserve a re-examination. I had some figures assembled at my request by Mr. Stam showing that we could drop the depletion allowance to 22.5 percent and it would bring in an additional $160 million in revenue, and we could drop the maximum effective rate limitation on individual incomes from the present 87 percent down to 60 percent and lose $130 million.

And if you tied the two together—that is, dropped the depletion allowance to 22.5 percent and reduced the maximum effective rate limitation on individuals down to 60 percent—you would make a long overdue adjustment on our tax laws and pick up an additional $30 million. With the permission of the chair, I place in the record a copy of the bill which I introduced on June 13, 1961, and an accompanying memorandum by Mr. Colin F. Stam, Chief of Staff of the Joint Committee on Internal Revenue Taxation. (The bill and memorandum follow:)

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, June 7, 1961.

Hon. JOHN J. WILLIAMS,
U.S. Senate,
Washington, D.C.

DEAR SENATOR WILLIAMS: As you requested the staff has prepared a draft of an amendment (attached) to reduce the overall maximum limitation on individual income tax from 87 percent at present to 60 percent over a 3-year period, and to lower the rate of percentage depletion in the case of oil and gas wells from 27½ percent at present to 20 percent, also over a 3-year period.

With respect to the overall limitation on individual income taxes, the draft provides for a three-step reduction, at 1-year intervals, commencing in 1962. For taxable years beginning in 1962, the rate would be 75 percent; for taxable years beginning in 1963, the rate would be 65 percent; and for taxable years beginning in 1964 and thereafter, the limitation would be 60 percent. The staff estimates that these changes in the overall limitation would cause a reduction in revenues to the Federal Government in the amounts shown in the following table.

Maximum effective rate limitation (percent):	Revenue loss (millions)
75	$25
65	80
60	130

The draft also provides for a three-step reduction in the 27½ percent depletion allowance for oil and gas, at 1-year intervals, commencing in 1962. Under the draft, for taxable years beginning in 1962, the rate would be 25 percent; for taxable years beginning in 1963, the rate would be 22½ percent; and for taxable years beginning in 1964 and thereafter, the rate would be 20 percent.

It is extremely difficult to estimate the effect of small changes in the depletion rate for oil and gas, because we do not have the data we need concerning the present effect of the 50-percent limitation, and because the data on depletion claimed on individual income tax returns is incomplete. Consequently, our estimates for your proposal are rough.

Tax year	Proposed depletion rate for oil and gas	Estimated revenue gain over present law
	Percent	*Millions*
1962	25	$75
1963	22½	160
1964	20	250

I hope this will be helpful to you.

Sincerely yours,

COLIN F. STAM, *Chief of Staff.*

[S. 2069, 87th Cong., 1st sess.]

A BILL To further amend the Internal Revenue Code of 1954, as amended.

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

SEC. . REDUCTION OF OVERALL LIMITATION ON INDIVIDUAL INCOME TAX.

(a) 1962.—With respect to taxable years beginning after December 31, 1961, and before January 1, 1963, section 1(c) of the Internal Revenue Code of 1954 (relating to overall limitation on individual income tax) is amended by striking out "87 percent" and inserting in lieu thereof "75 percent".

(b) 1963.—With respect to taxable years beginning after December 31, 1962, and before January 1, 1964, such section is amended by striking out "75 percent" and inserting in lieu thereof "65 percent".

(c) 1964 AND SUBSEQUENT YEARS.—With respect to taxable years beginning after December 31, 1963, such section is amended by striking out "65 percent" and inserting in lieu thereof "60 percent".

SEC. . REDUCTION OF DEPLETION ALLOWANCES WITH RESPECT TO OIL AND GAS WELLS.

(a) 1962.—With respect to taxable years beginning after December 31, 1961, and before January 1, 1963, section 613(b)(1) of the Interal Revenue Code of 1954 (relating to percentage depletion in case of oil and gas wells) is amended by striking out "27½ percent" and inserting in lieu thereof "25 percent".

(b) 1963.—With respect to taxable years beginning after December 31, 1962, and before January 1, 1964, such section is amended by striking out "25 percent" and inserting in lieu thereof "22½ percent".

(c) 1964 AND SUBSEQUENT YEARS.—With respect to taxable years beginning after December 31, 1963, such section is amended by striking out "22½ percent" and inserting in lieu thereof "20 percent".

Secretary DILLON. You mean you would recommend that, Senator, without any change in the rates below 60 percent?

Senator WILLIAMS. Yes, sir; when these two proposals are coupled together.

Secretary DILLON. I do not think we would agree with that, because we do not think it is equitable to just reduce the higher rates and not also make the adjustments up and down in the rate structure.

Senator WILLIAMS. This would be making adjustments with the same class of taxpayers and picking up revenue at the same time.

I think that you have said that you thought the individual rates were too high.

Secretary DILLON. I agree they are, but when we recommend the change, we will recommend one up and down the line, not just for the top rates.

Senator WILLIAMS. What I was suggesting here is that you could adjust the income of those who are all in this same bracket.

You have no recommendations, as I understand it, to change the present oil depletion, notwithstanding the example which President Truman cited; is that correct?

Secretary DILLON. Not at this time.

Senator KERR. Would the Senator yield further there?

Senator WILLIAMS. Sure.

Senator KERR. Was there any recommendation made on that during the 8 years beginning in 1953?

Senator WILLIAMS. No, sir; not to my knowledge, nor for the 8 years prior thereto except as President Truman did.

Senator KERR. Fast thinking but poor application.

Senator WILLIAMS. That is right.

I am glad to note that this is being studied. And you think there is a possibility that some recommendation may be included in the next tax bill that comes before us?

Secretary DILLON. Certainly the study will be completed by then, and if we do not have a recommendation specifically on this, we will have very good reasons why not.

We would expect we will have recommendations on all the major subjects of this type.

Senator WILLIAMS. Since this proposal is apparently something that is noncontroversial, I thought maybe it could be included in here.

In connection with the withholding provisions on interest, I notice that on page 27 you state that:

The mechanics of withholding on dividends and interest will be simple. It will not be necessary for the payers to furnish information statements either to the Government or to the recipients of dividends or interest.

Now, I am not taking exception. You may be right. I am just asking for information. Would you explain just how that will work with the individual who owns a coupon bond?

Secretary DILLON. The individual who owns a coupon bond will go to the bank and clip his coupon and will take the coupon to the cashier where he ordinarily cashes it, and he will get paid just 80 percent of the face value of that coupon.

Senator WILLIAMS. Is there anything under this bill which says that he must take it to the cashier of the bank? Is it not under existing law permissible that if I want to I can turn one of those over to you; they are a negotiable piece of paper the same as a check?

Secretary DILLON. I assume you could turn it over to anybody, but if anyone gave you more than 80 percent of what it is worth, they would be very foolish because that is all that it is worth.

Senator WILLIAMS. Based on this bill. But what I am asking—and I am not arguing with you—how will they know?

In effect, as I understand it, you are devaluing these coupons by 20 percent as far as negotiable——

Secretary DILLON. That is correct.

Senator WILLIAMS. How are you going to get that information out to the people, because, as I understand it, these interest coupons are negotiable. If you want to stop at a gas station or down at one of the department stores, they are a negotiable piece of paper? The U.S. Government has some of these bonds out.

Secretary DILLON. You mean a Government coupon?

Senator WILLIAMS. Government or corporation, either one, but we will use a Government coupon that is due April 1. When it says April 1, that is payable to the bearer $100, we will say, interest. It does not say $80.

Secretary DILLON. That is correct, but I do not think many coupons are used in that fashion.

In any event, we assume that those who have lots of coupons and are fortunate enough to have them will soon find out that there is a 20-percent withholding tax on them.

Senator WILLIAMS. Perhaps.

You say here it will not be necessary for the payers—that is, the banks—to furnish information statements either to the Government or to the recipient of dividends or interest.

Now, these coupons come in. They have no names on them. You do not sign them.

Secretary DILLON. That is right.

Senator WILLIAMS. If the bank does not furnish an information return and they get these coupons from 40 different people in a day, and if you or I, as one of the owners of these coupons, deposit them, we do not get anything to show that we have had this withheld from us——

Secretary DILLON. That is right.

Senator WILLIAMS. How do you administer it?

Secretary DILLON. We know that you cannot cash a coupon in a bank without there being a withholding on it, and the individual, when he reports his income, he knows what income he got, he writes that in on his tax return.

There is a line underneath that figure which says "enter here 25 percent of the figure."

Senator WILLIAMS. I am not arguing, just asking.

Secretary DILLON. Yes.

Senator WILLIAMS. Perhaps you know.

Now, you cash this coupon.

Secretary DILLON. That is right.

Senator WILLIAMS. The bank does not keep a record of the fact that I cashed that coupon there?

Secretary DILLON. No.

Senator WILLIAMS. You say that is not necessary?

Secretary DILLON. No.

Senator WILLIAMS. It is not necessary that they keep any record that John Williams cashed this coupon. And they take out 20 percent.

Suppose I am in the 80-percent bracket and want to forget it?

Secretary DILLON. You are quite correct there, Senator. This does not in any way collect income for those who do not put on their tax return income from interest or dividends over 20 percent.

However, what it will do—and there is such a gap——

Senator WILLIAMS. Yes.

Secretary DILLON (continuing). Because we feel that this particular measure will recover only about three-quarters of the gap that exists—it will narrow the field down and allow the Internal Revenue Service to concentrate on those cases of higher income people that show up on ADP as having interest and income, to be sure they have reported all of their interest income.

Senator WILLIAMS. How will that show up if I do not tell you? If I am in the 80-precent bracket and I do not want to pay the other 60 percent and I just forfeit the 20 percent, how will that show up?

Secretary DILLON. That will not show up; you are quite correct.

That will not show up in case of coupon bonds. It will show up in the case of bank interest.

Senator WILLIAMS. It will show up in the case of bank interest?

Secretary DILLON. That is right.

Senator WILLIAMS. It will show up in the case of the E bonds?

Secretary DILLON. It will show up in the case of dividends that are registered in names of people.

Senator WILLIAMS. It will show up in the case of all of those who own coupon bonds who are in the low brackets, but all of those

who are in the bracket above 20 percent where it would pay them to forfeit it and not report and not claim the 20 percent——

Secretary DILLON. Well, that is fraud, of course.

Senator WILLIAMS. Under existing law as well; is that not correct?

Secretary DILLON. That is fraud.

Senator WILLIAMS. Sure, it is fraud, but is there any statistics to show those who are in the upper brackets are any more honest than those in the lower brackets?

Secretary DILLON. No; certainly not.

Senator WILLIAMS. Well, this is protection, supposedly, against all who have low incomes, is it not?

Secretary DILLON. Not proof.

Senator WILLIAMS. No?

Secretary DILLON. It just collects the tax.

Senator WILLIAMS. It collects the tax on all of those who are in the lower brackets, but to catch anyone in the upper bracket who wanted to evade the taxes, there is nothing in this bill, as I see it.

Secretary DILLON. Nothing in this bill that increases the present possibilities of enforcement over what we have today, and nothing that decreases it.

It stays just the same.

Senator WILLIAMS. Nothing in this bill that would decrease it, I agree with you, but there is nothing in this bill, as I see it, that would increase the enforcement provisions on those income tax payers who are in the bracket from 40 percent up, though it may vary, is that correct?

Secretary DILLON. That is correct. It would just allow the Internal Revenue Service to concentrate more effort on this particular group because the rest of it will be taken care of automatically.

Senator WILLIAMS. But do you not think it is a little unfair to single out the taxpayer that has but just a small amount of income from interest or dividends with a complete withholding and let the large fellow out?

Now, if you are going to do this, should you not have the names of these people reported or at least retained by the bank, and available?

Secretary DILLON. No, Senator; I see no difference between this and our present withholding on wages and salaries. In our present system of withholding on wages and salaries, we withhold only a small amount, not the whole amount.

Senator WILLIAMS. But there is this important difference: True, you only withhold a small amount on the man that has got a hundred-thousand-dollar income, but his name is sent in to the Federal Government?

Secretary DILLON. That is correct.

Senator WILLIAMS. And in this instance you do not send any name in. There is an information return in the withholding of salaries?

Secretary DILLON. That is right.

Senator WILLIAMS. There is no information return here though, as I see it, on anyone who is in the upper bracket, as far as income from coupon bonds is concerned; is that right?

Secretary DILLON. That is correct as to coupon interest, although information on anyone that is in upper or lower or any other income bracket——

Senator WILLIAMS. But the lower bracket, you really would not need the information return, because you pretty much have your tax anyway?

Secretary DILLON. That is right.

Senator WILLIAMS. And they would lose if they did not take advantage of it and claim the credit?

Secretary DILLON. They would not have the same opportunity, which I do not think that any of them would want, to defraud the Government.

That is all you are saying.

Senator WILLIAMS. That is right.

I just wondered if you have not left something out—and, assuming that we are going to do it, should we not do it right and not just single out one group of people and say:

"We think you are honest enough that you will pay your taxes just because you have got a large income"?

Secretary DILLON. We don't say that at all. They are withheld on in just the same way, and the Government will have to try and get the funds the best way it can.

The only way we can get around that is to do what you are suggesting:

That every time a man came in and cashed a coupon, we would have to ask him what his income was.

Senator WILLIAMS. No.

Secretary DILLON. If he said his income was higher, then you would fill out a form and send it in.

Senator WILLIAMS. No; I beg your pardon.

You could do it the same as you do on withheld taxes. You could still take the 20 percent, but you could keep the names.

Secretary DILLON. That is what I meant. You would have to ask his name.

Senator WILLIAMS. Certainly, but you would not have to ask him anything else, if you were going to take 20 percent, but they would have to keep the names of the people that cashed the coupons.

Secretary DILLON. That would be a great deal of extra work for the banks and the payors and we do not think it would be worth while for the results that would flow from it for most taxpayers.

Senator WILLIAMS. Now, one other question here. Has there been any consideration given, since we are figuring on getting revenue which has not been declared, to racetrack winnings?

Do you think they are all declared, all paid. Have you considered any withholding at the track?

Secretary DILLON. I am not an expert on that. I happened to be watching a television show yesterday afternoon called Meet the Press and the Commissioner of Internal Revenue was on there and they asked him a similar question and he said there were arrangements with the tracks and that the cooperation was very good for the Internal Revenue Service to get the names of all large winners.

He says that has worked very well.

Senator WILLIAMS. He said he got the names of the winner of the daily double.

Secretary DILLON. That is right. You saw the same program.

Senator WILLIAMS. Have you had better cooperation from the racetracks in getting information returns than you have from the banks?

Secretary DILLON. I am not aware of that.

Senator WILLIAMS. Well, seriously speaking, if you have not, then why exempt them?

I understand from the figures that were supplied to me that there is about $3.3 billion annually changes hands on the parimutuel tracks. That is the turnover on the harness and thoroughbred racing.

I recognize it is not all profits, but if you are going to start a withholding tax, have you given any consideration, to withholding on track winnings or do you operate on the basis that the widow who has got her savings account in the bank is a little less apt to pay her tax than the man that goes to the track and makes some money?

Now, if you are going to put this on the basis of collecting taxes——

Secretary DILLON. We do collect from the big winners at the tracks. They are the people that are apt to win. As you pointed out, other ordinary racegoers do not generally come out ahead.

Senator WILLIAMS. What reporting information do you require from the tracks?

Secretary DILLON. Well, as the Commissioner of Internal Revenue said, he has an arrangement where they give him the names of individuals who win daily doubles.

Senator WILLIAMS. I am not an expert on the track, but I understand that that is a small part of. What is paid out.

Secretary DILLON. Those are the winners, though.

Senator WILLIAMS. Yes.

Secretary DILLON (continuing). They go home with money in their pockets that is so big that they probably keep it for a while.

Senator WILLIAMS. But they do not necessarily report the other bets at all. You do not have any information at all?

Secretary DILLON. No. I will be glad to give you a report on exactly the kind of cooperation the Internal Revenue Service has with the track.

Senator WILLIAMS. The Commissioner last night said that the only information he got was on the winner of the daily double.

Secretary DILLON. And other similar things, he said, so I do not know just what that meant. That may be large bets.

Senator WILLIAMS. I just wondered why if you were going to extend this withholding principle you did not try to make sure we get everybody in there, or were you leaving them out for reasons you thought they were paying their tax better than the others do?

Secretary DILLON. No; but just because we do not think that those are all profits, as you so well pointed out. They lose it as often as they win it.

Senator WILLIAMS. I notice that you have a provision in this bill here which would prevent industry from deducting their expenses for certain lobbying activities?

Secretary DILLON. That is in the bill. We do not have it in the bill. It is in the bill. We opposed it in the House and we oppose it here.

Senator WILLIAMS. You are recommending that that be stricken from the bill?

Secretary DILLON. That is right.

Senator WILLIAMS. Is your recommendation that industry should not be allowed its lobbying activities to be charged off as a necessary expense consistent with the recent ruling of the Civil Service Commissioner wherein he ruled that civil-service employees are expected to lobby for the administration's program?

Secretary DILLON. I read the debate on that the other day. That was connected with the Treasury-Post Office appropriation bill. Otherwise, it might not have come to my attention, so I cannot comment on that first hand.

But this other position has been a consistent position of the United States up to date for all these years. We do not allow the deduction of lobbying expenditures and never have.

Senator WILLIAMS. I understood that, but I was just making a comparison of the two there.

I notice that in the change of the deductions for business expenses, you state that restrictions should also be imposed on the amount to be deducted as business gifts and on travel expenses for vacations that are combined with business travel.

Now, would you care to comment on what you mean by the "travel expenses for vacations that are combined with business travel"?

Secretary DILLON. Yes.

The clearest example is if a convention of some sort is held for 1 week in London and people attending the convention travel to London and then after that they spend a month touring around the continent of Europe and then travel back home and they get their whole travel expense to Europe and back paid because of the convention in London.

We think there ought to be some sort of an allocation in that case. That is a clear-cut case.

Senator WILLIAMS. I agree with your objective and I just asked for the explanation.

Secretary DILLON. Yes.

Senator WILLIAMS. Now, how will that affect certain travel by representatives of the executive or legislative branch?

Secretary DILLON. I do not quite understand what the comparison is. I think most of them, when they travel to places like that, go and come back.

Senator WILLIAMS. We assume that everybody comes back. But would you say the same rules should apply?

Secretary DILLON. I would think the same rules that apply in one place should apply everywhere, surely.

Mr. Chairman, I had one thing that I wanted to maybe bring to the committee's attention as a result of this morning's discussion, and that was on the question of the date of the effectiveness of the credit.

I was informed during the recess that at the time of the enactment of the 1954 Code, which became law on August 16, 1954, it introduced in its section 167 the new methods of accelerated depreciation, double declining and sum of the digits, and these were allowed to be used for taxable years beginning after the preceding December 31, 1953, with respect to property acquired after that date, which is exactly the same as the proposals we have here.

So, apparently, there is a precedent, because the Congress in 1954 did exactly the same thing as is in the House bill.

Senator KERR. May I ask the Senator from Delaware one question. As I understood it, you referred to the matter of the lobbying by civil service employees as being similar to the provision in the bill?

Senator WILLIAMS. No.

I asked if there was any similarity between the two, whether the proposals of the bill were consistent with the ruling.

Senator KERR. I thought the ruling with reference to the civil service employees was to their right to lobby, not as to the charging of the expense they had in connection with it.

Senator WILLIAMS. It is partly both.

Senator KERR. I did not know anything in the ruling that gave them any tax deduction, and I just wondered if the Senator thought that under the constitutional provision that the right to petitioning the Congress should never be denied might not give the civil service employee the right to talk to his Congressman, if he wanted to.

Senator WILLIAMS. I do not and, if you read the debate—you will find there was no question raised about the right of the civil service employee to petition Congress. That is specifically provided for, and was protected in the proposal which we offered.

Certainly, they do have that right.

What was provided, was a criticism of the recent ruling wherein it was declared the administration could use these civil service employees throughout the country to speak before what they called interested public groups, clubs, and so forth, and speak on behalf of, or defending, the administration's legislative programs. And the law, as I read it, clearly said they should not speak for or against pending legislation.

Senator KERR. But there was nothing in that order that had to do with the deductibility of the expenses in connection with it.

Senator WILLIAMS. Under that order their employer was charging it off as a normal expense, and I would say that that is a complaint that the Secretary of Treasury is making: That these business corporations are charging off their employees' lobbying activities as normal expenses.

Senator KERR. The Government is charging what they are paying off as a tax credit?

Senator WILLIAMS. Well, of course, I do not think we have gotten around to taxing the U.S. Government yet.

Senator KERR. I did not know it. I just wanted to find out——

Senator WILLIAMS. Whether the Senator from Oklahoma is proposing it or not, I do not know.

Senator KERR. No, no, I was just asking you, because if they were using it as a deductible item on the tax liability, I was going to ask the Senator what tax liability.

Senator WILLIAMS. It makes a part of creating this deficit which we find is developing, but of which we cannot see the end.

Senator KERR. We have seen the past of.

The CHAIRMAN. Senator Douglas?

Senator DOUGLAS. Mr. Secretary, I want to congratulate you on at least two phases of your testimony.

In the first place, I think you have made an extremely able statement, and the way in which you were able to answer difficult questions without consultation with your experts shows that you are a master

in this field and I think the country is very fortunate to have a man of your ability as Secretary of the Treasury.

In the second place, I personally appreciate very much the fact that for the first time in a decade a Secretary of the Treasury has appeared before the Senate and urged that certain obvious loopholes be plugged and certain obvious injustices be remedied, and I want to congratulate you on that.

I join with my colleague from Delaware in the hope that when we proceed to a more thoroughgoing plugging of the loopholes, that you will turn your attention to the 27.5-percent depletion allowance on oil and gas, and the depletion allowances for such rare and difficult objects as oyster shells, clam shells, sand and gravel and so forth, which also seem to be involved, and for which exploration is now encouraged by the tax laws.

Now, I would like to ask you, if I may, some questions about the proposal for the investment credit, and I would like to begin by asking you:

To what industries besides manufacturing will the proposed 8-percent investment credit apply?

Secretary DILLON. It will apply to all industries except the regulated public utilities.

It will apply in particular to the mining industry; it will apply to the railroads; it will apply to commercial enterprises; it will apply to agriculture.

I think those are the major elements.

Senator DOUGLAS. It applies to agriculture.

Then will the purchase of a fertilizer spreader to raise potatoes in Idaho receive an 8-percent investment credit in order that Idaho potatoes may hold their own in competition with the potatoes of Belgium and Holland?

Secretary DILLON. I do not know whether that is the reason, but the fertilizer spreader or a tractor or any other piece of agricultural equipment will be eligible for the credit.

Senator DOUGLAS. Will it apply to a huge cotton planter in the South, to help raise more cotton, which is already in surplus?

Secretary DILLON. Yes.

Senator DOUGLAS. And to machinery which will enable the wheat farmer out in the Dakotas to produce more wheat when we already have, I believe there are now 1.4 billion bushels of wheat in storage?

Secretary DILLON. It applies to all agricultural equipment. We did not feel that there was any justification for eliminating this great segment of our industry from this benefit for modernization.

Senator DOUGLAS. An automatic weed eradicator in the asparagus fields of New Jersey would be very valuable in protecting the asparagus industry of the United States from the rigors of competition from abroad, and, thus, increasing the growth rate of American agriculture?

Secretary DILLON. I think that it is certainly clear that what we do in the way of giving the credit to agriculture is probably less important, generally is not of comparable importance relative to industry, in terms of competition from abroad.

The same thing would apply largely to commercial services. But, certainly——

Senator DOUGLAS. I want to come to that. Now, we will come to trade.

If a supermarket buys 100 pushwagons in order to increase the speed with which the suburban housewife may move through the supermarket, will this receive an 8-percent investment credit in order that the American supermarket may excel those in Holland, Belgium and West Germany?

Secretary DILLON. It will make our commercial distribution, I would hope, more effective. It will release individual labor for more effective work in industry.

Senator DOUGLAS. And, similarly, with the credit be given for the installation of more shelves in which deodorants and other facial and body aids may be purchased? Will this increase the productive efficiency of the American public and aid in the competition for foreign markets with the chemical industry of Germany?

Secretary DILLON. I am not sure that a shelf is a piece of equipment.

Senator DOUGLAS. Well, then, would an atomizer to kill flies in the supermarket, which is a certain piece of tangible property, receive an 8-percent investment credit in order that the glories of the American trading system may show its superiority to those of continental Europe?

Secretary DILLON. I think that may be so.

Senator DOUGLAS. Would this apply to tangible personal property in the field of commercialized recreation?

Secretary DILLON. Commercialized recreation, yes.

Senator DOUGLAS. Would a ski lift in Sun Valley receive the 8-percent investment credit?

Secretary DILLON. I could not answer that. I do not know whether that is equipment or whether that is real property.

Senator DOUGLAS. It would be used as an integral part of what is defined as the production of utilities?

Secretary DILLON. An automatic pin-setting machine——

Senator DOUGLAS. Let us put it this way:

Would you say that the purchase of skis and snowshoes by Sun Valley, which is certainly tangible personal property, would receive an investment credit?

Secretary DILLON. They are not machinery and equipment. They are not——

Senator DOUGLAS. It is tangible personal property?

Secretary DILLON. I think you will see the bill applies to depreciable equipment and I do not think personal skis are depreciable equipment, Senator.

Senator DOUGLAS. Then what about the ski lift?

Secretary DILLON. I do not know whether that would be or not.

Senator DOUGLAS. Well, put it this way: Would the installation of a popcorn machine in the Yankees' ball park, which would last over 8 years, be subject to the 8-percent credit?

Secretary DILLON. If that is machinery or equipment—

Senator DOUGLAS. It is certainly machinery, yes.

Secretary DILLON. Then it would be, I would assume.

Senator DOUGLAS. And the purpose of this, I assume, is so that American industry may have:

(a) A faster rate of growth; and,
(b) That it may compete more effectively with the European market.

Secretary DILLON. Senator, I agree with you that these may be considered anomalies, but that is not the purpose.

The reason for their inclusion is that we did not feel that it was possible or practicable to start a whole new era in the tax law by trying to divide out just where was industrial equipment and where was commercial equipment, and what should be helped and what should not be helped, because we would have had to write hundreds of pages of tax laws.

Senator DOUGLAS. You have taken in a pretty broad territory.

Secretary DILLON. I think that is correct, I agree with that.

Senator DOUGLAS. And even assuming it is a good idea, is not the question whether you should restrict it somewhat?

I do not wish to humilitate you, but I would like to go on with some further illustrations, if I may.

Secretary DILLON. It might well be restricted, if the committee decided that it can do it.

Senator DOUGLAS. Would an escalator in a movie house be regarded as a piece of machinery and equipment?

Secretary DILLON. To that I would have to again give the same answer:

I am not sure whether that is attached or whether it is equipment. If it is a structural part of the building it would not be eligible for the credit.

Senator DOUGLAS. A movie house in the same way?

Secretary DILLON. Same way, wherever it was.

Senator DOUGLAS. The justification for this would be to increase the growth rate in the United States and also to enable the American movie houses to compete more effectively with foreign movie houses so that Americans would stay in the United States and would watch movies?

Secretary DILLON. It certainly would help the escalator business.

Senator DOUGLAS. Or possibly the foreigners would come here in order to avoid walking up stairs?

Secretary DILLON. It would employ people making escalators. But, on reflection, I am quite sure that an escalator would not qualify for the credit.

Senator DOUGLAS. Now, may I ask this:

Would this include the installation of automatic cocktail mixers in taverns?

Secretary DILLON. I think it includes all restaurant and bar equipment.

Senator DOUGLAS. And this is done to increase the growth rate and also enable American industry to compete more effectively with foreign industry?

Would the installation—let the record show the Secretary did not reply.

Senator GORE. Mr. Chairman, in all fairness, I think the record should show that he did smile.

Senator DOUGLAS. Would the installation of glass-top table in the 21 Club in New York be regarded as equipment upon which an 8-percent investment credit would be given?

Secretary DILLON. Any equipment having a useful life of more than 4 years would get at least one-third of the credit.

Senator DOUGLAS. Yes.

I take it the answer is "Yes."

And this also will increase the growth rate, I assume, and will enable American industry to compete more effectively.

Will the provision of floodlights in a burlesque house of dubious reputation get an 8-percent investment credit?

Secretary DILLON. I hope we do not have any more such dubious reputation houses.

Senator DOUGLAS. But I mean, assuming that they exist, would they get an investment credit?

Secretary DILLON. Again, that is a piece of equipment, if the law, as presently written, is passed.

Senator DOUGLAS. Are you not interpreting economic growth rather broadly?

Secretary DILLON. If this committee can find a v y in which to change this, it would be all right, but I would like to point out here, just to make it clear, that all the other alternative suggestions for providing incentives to growth have just the same problem. They all apply to all sorts of equipment. There is no difference in that regard between the suggestion that we have made and the alternative suggestions for triple declining balance depreciation and more rapid depreciation of one type or another.

Senator DOUGLAS. Mr. Secretary, in 1954, your predecessor, Secretary Humphrey, appeared before this committee and asked that a 4-percent dividend credit be allowed in order to stimulate, as he said, the percentage of corporate financing which would be conducted through the purchase of equity shares.

I think the Senator from Tennessee——

Senator KERR. Will the Senator yield there?

Senator DOUGLAS. Not for too long. I do not want you to take over completely, Bob. For 30 seconds.

Senator KERR. Did the Secretary ask for larger than 4 percent?

Senator DOUGLAS. Yes, he did. I think it was 15 percent.

Senator KERR. I just wanted that for the record.

Senator DOUGLAS. Now, I take it from your statement that you have found that 4 percent which was granted has had no effect in stimulating the percentage of corporate financing carried on by the purchase of equities?

Secretary DILLON. No, it has not.

Senator DOUGLAS. Yet, you think that an 8 percent investment credit will stimulate the total investment?

Secretary DILLON. Very much so because it is a totally different type of credit.

Senator DOUGLAS. If Mr. Humphrey was wrong on 4 percent, may you not be wrong on 8 percent?

Secretary DILLON. I do not think in this case that we are likely to be wrong this same type of law has been in effect in many other countries, and it has clearly stimulated investment there. So I assume the same thing would happen here.

Senator DOUGLAS. Now, as I remember it, in the draft which you submitted last year to the House Ways and Means Committee, you

provided that the investment credit would only be granted on the net investment, the investment over and above depreciation. Is that true?

Secretary DILLON. That was the original proposal. Well, now, it was not only on that. It would be a 15-percent credit on that, and then it was a 6-percent credit on the amount that was between 50 percent of depreciation and 100 percent of depreciation.

Senator DOUGLAS. But now this credit is allowed for gross investment so that a mere replacement of wornout machinery assumes the 8-percent credit as well as an addition.

Secretary DILLON. After full consideration in the Ways and Means Committee it was felt that the formula which we had suggested had more disadvantages than advantages, although I think they recognized the fact that it would provide greater stimulus to the growth of rapidly growing companies. But it would work against the railroads or some industry of that nature and, therefore, they decided the present form of the credit would be preferable.

Senator DOUGLAS. The bill in this present form provides for this investment credit for the investment that would be made anyway in the absence of credit; isn't that true?

Secretary DILLON. That is true. And in the same fashion as any sort of further acceleration of depreciation——

Senator DOUGLAS. It is, therefore, a bonus on investment which would occur anyway.

Secretary DILLON. To the same extent that any such change in depreciation would be, yes.

Senator DOUGLAS. Well, if we want to stimulate investment, wouldn't it be better to have the credit on the marginal decisions, on the investment which would not be made in the absence of such credit or the investments in excess of the previous rate of investment either for the industry or for the——

Secretary DILLON. Possibly the previous rate of investment if we can find the proper formula. What you suggest might have been very great effect, Senator, and might be more reasonable.

The formula we suggested did not work in many cases because, for instance, the railroads have very large depreciation. Unfortunately, they do not have very large earnings now. Therefore, any percentage formula over and above depreciation was of no help to them. So we had to find some other formula. It turned out that there were a good many industries of that nature, and many accountants testified that there would be all sorts of accounting problems as to what was and what was not proper depreciation, and, therefore, the Ways and Means Committee did decide this was the simpler method.

I must say we were convinced that tax simplification, that the advantages of ease of administration, were very large in this simple approach compared to the other.

Senator DOUGLAS. My offhand judgment is that you are going to be paying bonuses to firms which do not need the bonuses in order to stimulate investments for items which are of very dubious value in our economic growth and in our competition with foreign countries, as far as that is concerned.

But I have a further objection as of this moment to this plan, and that is whenever we make deductions from taxes based on ways in which income is spent, we open up the door to tremendous abuses.

Congress has now before it or the Senate has before it, H.R. 10 which would provide partial tax exemption for voluntary contributions to the self-employed for pensions.

The Senator from Tennessee and I have opposed that measure, and I assume we will oppose it in the future. But it may well pass.

If this passes, the same principle will inevitably be extended to civil service, to those on social security, to those on railway retirement, to a whole range of benefits.

Every one of us gets a big volume of correspondence asking that similar deductions be made for the cost of educating children up to and through the college level.

If you make a deduction, and this is a deduction from taxes not from taxable income, but from taxes, there will be claims that you should make similar deductions for the purchase of homes in order to encourage homeownership.

I think in your very laudable desire to close loopholes you are now opening up one of the possibilities for the biggest loopholes of all.

Now, my mind is not closed on this matter, but these are the thoughts which have occurred to me. I wonder if you want to make any comment?

Secretary DILLON. Yes, Senator, I would be glad to.

In the area of general coverage, certainly the area that we are most interested in is that which has to do with industry and manufacturing, to keep our industry competitive with that in the rest of the world. I think that the great bulk of expenditures would go there.

If the committee can find any reasonable way in which it can agree on any limitation of the present coverage that makes sense and eliminates areas which obviously we do not want to or particularly care about promoting or which do not need promotion, that would be perfectly acceptable to the Treasury.

We did have difficulty ourselves in finding any such area. We wanted to avoid the idea that the Government is trying to draw too sharp a line as to what businesses are good businesses and what businesses are bad businesses, so we could have this wide open to our economy and to general economic laws to make the decisions.

Now, as to your final observation on this being a deduction, this is a thing that is inherent in any tax law which has to do with depreciation when that tax law gets beyond what is a strictly realistic depreciation allowance. And we are faced with this very difficult problem that the rest of the world with which we are competing has seen fit to go beyond that, and we have to do something similar or be left behind in the procession. We think that this method is the cheapest and the safest for the Government and would, therefore, choose this.

Senator DOUGLAS. Mr. Dillon, I have just got one final question on another point. A corporation doing business in the Western Hemisphere outside of the United States has to pay a tax of only 38 percent instead of 52 percent; is that correct?

Secretary DILLON. Well, that is correct. That is the U.S. tax, so that it works that way if the foreign tax is less than 38 percent; yes.

Senator DOUGLAS. Now, this applies not to various countries south of the Rio Grande but also to Canada; isn't that true?

Secretary DILLON. It applies to Canada by law, but not to any practical effect because of the reason that Canada has a tax of 50 percent

itself. So it is of no use to investments there, and that is why there are practically no Western Hemisphere corporations that operate in Canada.

Senator DOUGLAS. You prepared a memorandum on the location of certain tax havens. I believe you state the income tax in the Bahamas is zero; is that correct?

Secretary DILLON. That is correct, with respect to income from foreign sources.

Senator DOUGLAS. And in Bermuda, zero?

Secretary DILLON. Zero.

Senator DOUGLAS. And in Liberia, zero?

Secretary DILLON. Right.

Senator DOUGLAS. And in Panama, zero?

Secretary DILLON. Zero, as to foreign income.

Senator DOUGLAS. What about the Virgin Islands?

Secretary DILLON. I would have to get you what the tax situation is there, Senator. I do not know.

Senator DOUGLAS. I know you cannot have every fact at your fingertips.

Secretary DILLON. I do not know whether they have this right. I have the memorandum that you were furnished, which does not list the Virgin Islands.

(The following material was submitted for the record:)

Virgin Islands no longer available as tax haven. U.S. laws apply but the tax is collected by the Virgin Islands government. Since 1958 (sec. 941 of the Internal Revenue Code) the islands' right to grant refunds has been limited to corporations that do more than 50 percent of their business in the Virgin Islands and which have no more than 20 percent of their income from U.S. sources.

Senator DOUGLAS. Now, in brief, what is your proposal to plug these evasions?

Secretary DILLON. Well, we have two proposals, in brief. One is to abolish the present privilege of deferring income earned by a foreign subsidiary, a subsidiary of an American company, abroad. This would apply to all developed areas.

We have to then go beyond that to plug the loophole that may be available in an underdeveloped area, which makes itself into a tax haven for income earned on business conducted outside the area.

The present tax haven provisions in the House bill pretty well do that. They are pretty strict, with the one exception that they do allow income that is earned in Europe or dividends and interest that are earned from another developed area to avoid taxation if they are then reinvested in an underdeveloped area. That, in effect, still maintains a certain incentive, certain advantage, to investment in Europe to obtain this tax-free money for investment in underdeveloped areas. We do not think that is logical, so we think that ought to be eliminated.

But except for that one principal problem I think that the House bill does pretty well cover the main tax haven area. It barely touches the deferral area, and we are recommending that it take care of this problem.

Senator DOUGLAS. Do I understand Lichtenstein is also a tax haven with no rate of taxation on income from foreign sources, and 3 to 12 percent tax on domestic operations?

Secretary DILLON. That is correct.
Senator DOUGLAS. And Switzerland is a tax haven?
Secretary DILLON. That is right.
Senator DOUGLAS. Is it true that in some of the cantons of Switzerland the corporation tax is as low as 12 percent?
Secretary DILLON. Well, the general tax, I think, in Switzerland for income that is earned from outside, that comes in, is probably lower than that. It is probably in the area of 5 to 10 percent; something like that.
Senator DOUGLAS. I think we all noticed the article in the New York Times this morning on page 33 of the financial section where a corporation called Manuscripts, Inc., wants to put famous writers on a salary, having them live abroad and in this way they would get the advantages, supposedly, of the low rates of taxation in these tax havens.
I quote one paragraph:

> "A $100,000-a-year writer working in the United States might net only $40,000 after deductions and exemptions and taxes" explains John L. Cady, one of the founders of (but not a stockholder in) Manuscripts, Inc.
> "If employed by Manuscripts, Inc., however, and performing his services in a foreign country as a bonafide resident, his spendable income would jump to about $80,000," said Mr. Cady, who also is tax director of McGraw-Hill Book Company, Inc.
> Mr. Cady said that in this hypothetical case the remaining $20,000 of income would go for agent's fees, which are usually 10 percent, and to Manuscripts, Inc.

This is a description and, Mr. Chairman, I would like to ask that at the conclusion of the testimony of this morning that this article be included.
The CHAIRMAN. Without objection.
(The article referred to follows:)

COMPANY OFFERS WRITERS TAX DEAL—IT WOULD GIVE THEM SALARIES WHILE WORKING ABROAD IN RETURN FOR BOOK RIGHTS—CONCERN CITES SAVINGS—PAY NOT TAXED BY U.S., BUT ROYALTIES ARE—PUBLISHERS ANGERED BY PROJECT

(By Gay Talese)

A small New York corporation with neither an office nor telephone is now trying, among other things, to work out tax advantages for best-selling authors.
If the corporation, called Manuscripts, Inc., succeeds, it could profoundly shake up the book industry, and might encourage more American writers to live abroad as "employes" of the corporation, thereby saving tremendous amounts on taxes.
"A $100,000-a-year writer working in the United States might net only $40,000 after deductions, exemptions and taxes," explained John L. Cady, one of the founders of (but not a stock holder in) Manuscripts, Inc.
"If employed by Manuscripts, Inc., however, and performing his services in a foreign country as a bona fide resident, his spendable income could jump to about $80,000," said Mr. Cady, who also is tax director of McGraw-Hill Book Co., Inc.

FEES ARE CITED

Mr. Cady said that in this hypothetical case the remaining $20,000 of income would go for agents' fees, which are usually 10 percent, and to Manuscripts, Inc.
Normally, a publishing house advances a writer a certain amount of money when he makes a contract for a book. It gives him more money when his book is satisfactorily completed, and still more money in royalties if his book sells well.
But at Manuscripts, Inc., the writer is not working for a publisher but for a corporation. He is an "employe." The corporation pays him a salary for the

rights to his work, which it then sells to a publisher. How large a salary the corporation pays the writer depends on how much it wants him. If he is a commercially successful writer living abroad, he can command a fantastic salary and, as an "employe," keep most of it.

"Generally speaking, the income earned abroad by American citizens permanently residing in other countries is not taxed by the United States," explained Harriet F. Pilpel, a lawyer active in literary and entertainment property.

WHAT THE LAW IS

Specifically, under section 911-A of the tax law, an American who is a bona fide resident of a foreign country is completely exempt from U.S. taxes on earned income—that is, for services as an employee (although he must pay earned-income taxes to the country in which he lives).

However, the American living abroad must pay taxes to the United States on any other income, such as dividends and royalties. For such income he is taxed by the Government exactly as if he lived here. Thus it is to a writer's advantage to receive money paid as salary and not as royalties.

Americans living in Britain pay a higher income tax than they would if they lived in the United States. In Switzerland, the income tax is lower than that of the United States. In Italy and France, a tax expert reported, the income tax is higher than in the United States, but nobody pays what he should.

Manuscripts, Inc., formed in 1959, has been functioning quietly, to be sure, because, as one corporation spokesman asked, "Why should we let everybody in publishing get in on our secret?"

Perhaps Manuscripts, Inc., whose stockholders remain anonymous, would have continued in obscurity this year except that it lately has become more active in trying to hire big-name writers.

Already, it says it has hired Robert Ruark. It has approached others, too, such as Truman Capote. This has aroused rival publishers, a few of which have charged Manuscripts, Inc., with literary piracy and with using tax advantages to entice big writers away from their publishing houses, and toward McGraw-Hill.

Though Mr. Cady says that no McGraw-Hill employes have stock in Manuscripts, Inc., or vice-versa, he does concede that Manuscript's stockholders are "friends" of McGraw-Hill.

MANY GO WITH M'GRAW

"Many name authors looked into the possibility of working for Manuscripts, Inc.," Mr. Cady said, "and even though most of them decided not to do so, a number of them decided to become McGraw-Hill authors anyway."

Such authors, he said, included Quentin Reynolds, Richard Bissell, Vance Packard, Don Whitehead, Abigail Van Buren, and Eugene Burdick.

Mr. Ruark is having his latest book, "Uhuru," published by McGraw-Hill, but he said he would write his next book, "The Last Safari," as an employe of Manuscripts, Inc.

In doing this, Mr. Ruark agreed to waive all rights to his work in return for his salary.

Among benefits he will receive are pension and insurance plans, tax advice and accounting services. These are benefits that Manuscripts, Inc., also hopes to use in attracting writers who are not residents of foreign lands.

Legislation recently has been proposed by the House Ways and Means Committee that would place a $35,000 annual ceiling on the exemption for income earned abroad by United States citizens. If passed, this could hurt such writers as Mr. Ruark.

Mr. Cady, along with Keith W. Jennison (now an editor at David McKay, Inc.), and others formed Manuscripts, Inc., in 1959.

After they devised their operation and organized investors, they hired John Tebbel, writer of a wide variety of books, as a test of tax laws.

They paid him $75 a week, he said, and he began a historical novel for them about George Washington's general, Nathanael Greene.

But, according to Mr. Cady, the new corporation soon ran out of money and, failing to get an advance from McGraw-Hill, it could no longer pay Mr. Tebbel. (He continued on with his book, incidentally, switched the plot from General Greene to Washington himself, and has sold this historical novel to Random House.)

Manuscripts, Inc., continued on, even though its first president, Mr. Jennison, resigned when he took the job at McKay. Mr. Cady says Manuscripts, Inc., has many risks it must take.

If it hires a Mr. Ruark and the book it produces flops, it will lose all the salary it paid the author.

The author also is free to sever the relationship, provided he returns the salary he has collected.

Senator DOUGLAS. I think it looks as though this outfit is trying to do some business with tax havens, and I hope that these sections of the act will be very closely studied to prevent such things as this.

I think it would be a fine thing for our writers to stay at home, frankly, at least to not get tax advantages for going out of the country, but also because we need their cultural and civilizing influences upon the Nation, and we do not want to have too many expatriates. [Laughter.]

Secretary DILLON. Thank you. Under the provisions of the House bill this would be partially answered. Under the provisions as recommended by the President, by us now, it would be completely answered.

Senator DOUGLAS. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Carlson?

Senator CARLSON. Mr. Secretary, I want to commend you for what I say is a very fine analysis of the bill that came over from the House. I can assure you that it arouses many questions that might well be asked, and I am sure every member of this committee can think of many. I have a few that I would like to bother you with. I assure you I am going to take a very little amount of your time.

I refer particularly to the section of the bill which provides this 3 percent credit, partial credit of 3 percent, for regulated utilities, electric power, gas and telephone companies.

Now, in your statement you state that the President's original proposal recommended that the credit not apply to regulated public utility corporations.

We find, however, that this does come over from the House carrying a 3 percent rate.

I would ask you this question: Is there any reason why this Committee should not follow the House provisions or why did they place this 3 percent in instead of seven?

Secretary DILLON. Well, there was a great deal of discussion in the House—I think probably the House report would indicate some of that.

The problem was that the electric utility business came and very strongly urged that it be given the benefit of this credit. The main thing they cited was the thing I mentioned in my statement, this problem of providing industrial power. For instance, they said, "unless we have this, and we want to build a new large facility to provide large quantitise of industrial power to a new aluminum factory or to a steel mill, we cannot do that. The steel mill itself could put in a generator and get the credit, and that would be unfair competition."

However, it was impossible as far as we could see to separate that from the area of consumer and commercial power where this credit would provide great problems in the ratemaking field.

There is a general feeling that it might be, that it probably would be, passed on to consumers relatively rapidly, and in that case it would not do the companies any good.

We also saw that the utility companies have grown and did not seem to have any problem, which is very well covered, very completely covered, in our Annex T, and did not seem to need this sort of stimulus.

Finally, one important thing in our mind was the interesting thing that the American Telephone & Telegraph Co. which, by itself, is one-third of all the utilities of the country, one-third of this amount, did not want the credit, and so stated.

The House gave it to them anyway because they, I guess, felt the same way. They did not know how they could divide them out from the other utilities, and a lot of small telephone companies, little independent telephone companies in the south and other part of the country, argued very strongly that they would like this and this would be helpful to them, their argument generally being based on the fact that they were not earning a full percentage that they were entitled to and, therefore, that even with this credit they would still not be earning it. So it would not be taken away from them in rate reductions, and they needed it to compete with the big company.

So after considering all these balancing items the House came to sort of a Solomon's decision and decided instead of giving nothing or giving them 8 percent, to give them half, 4 percent, and then when they reduced the bill to put it in balance they cut the 8 percent to seven, and the 4 percent to three.

So that is the history of what happened, and I think we can understand the reasons for the utilities' interest.

I might say that the effort put on by the utility companies to get themselves included in this probably was the most convincing argument that was presented before the Ways and Means Committee of the fact that this investment credit meant a great deal to industry and would mean more expenditures and better efforts. They came down and gave facts and figures on the extra amount of orders that they would place immediately if they were included as compared to what would happen if they were not. They did impress the House Ways and Means Committee and, therefore, they put them in and, as a result, as I mentioned, the Edison Electric Institute is one of the organizations that is strongly supporting the bill on account of being included.

But in spite of all that, we feel that on balance the utilities should not be included and should be omitted.

Senator CARLSON. What you are saying, Mr. Secretary, as I understand it, is that this committee is going to have to make a decision.

Secretary DILLON. That is correct. It is a complicated problem, and I think you should hear the witnesses and make your decision.

Senator CARLSON. Do you know of any regulated public utility that has not been meeting the service requirements or obligations that they should be required of in this Nation of ours?

Secretary DILLON. No. I think that is one of the reasons we did not feel that this was necessary. The excess capacity of the utilities has been gradually built up over the past years, and is now higher

than at any time at least since 1940, and they are in very good shape. So we did not think they needed this excess, this extra incentive.

Senator CARLSON. Well, no doubt, we will have witnesses from the industry. But do you know of any of the utilities that have been unable to raise all of the capital needed for expansion?

Secretary DILLON. Certainly all of the larger ones have been able to. There may be some small utility companies that had some difficulty, but none of the larger ones, because of their favored position with their relatively guaranteed rate of return and monopoly situation, have had great difficulty in raising the funds they need.

Senator CARLSON. Based on the House action, what is the reduction in the tax revenue as a result of the House provision in the investment credit section?

Secretary DILLON. I think it is $1,175,000,000 gross.

Senator CARLSON. That would be the total amount?

Secretary DILLON. That is right.

Senator CARLSON. Turning over to another section now, we are dealing with treaties, and the Secretary appears quite often before the Senate Foreign Relations Committee, the fact of the matter is just last Thursday, and in your statement this morning you suggested that the committee remove section 21, I believe, from the act.

Secretary DILLON. That is right.

Senator CARLSON. On the ground that the bill does not override any treaty provisions except the estate tax convention with Greece.

In the income tax treaty—and this has been handed me, and being on the Senate Foreign Relations Committee I am somewhat interested in it—in the income tax treaty with New Zealand, Article III, Section 2 reads as follows, in part:

> The industrial or commercial profits of a New Zealand enterprise shall not be subject to United States tax unless the enterprise is engaged in trade or business in the United States through a permanent establishment situation therein.

Now, under section 13 of the bill, are there not many cases where the undistributed profits of a foreign corporation are taxed to U.S. shareholders; are there not many cases?

Secretary DILLON. Under Section 13 we do follow the same procedure as we have followed for many years in our foreign personal holding company tax and do tax them. We feel that this is perfectly proper and has not caused us any trouble with foreign countries, and I am informed by our General Counsel that there is no problem in the case of any of our income tax treaties. This has been looked at by our General Counsel, and he tells me there is no problem.

Senator CARLSON. If I read it correctly, and I think I quoted correctly from Article III, Section 2, why wouldn't that be a direct violation of the New Zealand Treaty?

Secretary DILLON. The reason is because we tax the United States shareholder and we do not tax the New Zealand corporation.

Senator CARLSON. I noticed in the tables that you submitted, in your statement, that you estimate the revenue effect of the investment credit, without consideration of stimulative effect on the economy, a $1.35 billion. That is in table 3. In table 4 you estimate the effect in fiscal year 1963 at $465 million, after taking a partial account of its stimulative effects on the economy.

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My first question is whether there is any reason in table 3, where the stimulative effect is not taken into account, and you refer to the revenue effect when the legislation is fully effective, but in table 4 you take into account the stimulative effect and confine your estimates for fiscal year 1963; why that differential?

Secretary DILLON. I can explain that very simply. The reason that we take it into effect is one place and do not in the other is this: in the long-run effects of any tax bill, the way it has always been figured in the past, which we think is a perfectly proper way to figure, is to figure the gross revenue losses and the plusses of new gains. Actually any revenue loss which gives more money to the economy will help to stimulate the economy. That money will be spent somewhere and we will get part of it back in taxes. Conversely, with any additional new tax which takes money out of the economy, that money will not be spent, and there will be some reduction in the economy which will reduce our tax take elsewhere.

These things pretty well balance off, and for the future this is a proper way to estimate.

The reason for the difference in 1963 is this: that we are comparing it to a revenue estimate that has already been made and several of the revenue gaining features of the bill came into play only by fiscal year 1964. In these future cases the revenue estimates for the future years have not been made.

Now, when we are comparing this to the revenue estimate that was already made, which was made on the basis of gross national product of $570 billion, that estimate did not take into account the stimulative effect that would take place if this credit was passed, and if it went into effect and made this money available to the general public.

If we had assumed that, our estimate of gross national product would have been higher. It would have been $573 or $575 billion. If it had been that, then you could have taken off from that, it would have been proper to take off from that, the full gross effect of the loss of revenue. But since we did not count it in, we have to count it in in some way when we figure the 1963 estimates. So we counted it in on the net basis.

There is one other thing that comes into this particular difference in figures which you mentioned, and that is that you will recall we made a special recommendation, in view of the fiscal 1963 situation, that the limit in the House bill of 25 percent of taxes is the maximum possible writeoff to be maintained throughout the full calendar year 1962, and that this only go to 50 percent beginning January 1, 1963.

This would result in a revenue cost for the investment credit of some $240 million, $250 million less in fiscal year 1963 than would be the case thereafter.

So, instead of being a full year cost of $1,350 million, for the first year its gross cost would be about $250 million less or $1.1 billion.

So it is starting with that when we are applying the stimulative effects, and they work both ways.

You will notice that various items that we have here do not show as great a credit, the plus items, as they do on full year effect when we are talking about gross. They also have been written down to take account of the same economic effect that I mentioned to you earlier.

Senator CARLSON. Mr. Secretary, I am sure you will agree with me that these two tables that you have submitted here are going to be very important for the consideration of the committee, and those who testify here in the future on it, and I hope that if there is any statistical information that you can give us for the record that will assist us as to how you arrived at a particular variable answer on it, that would be greatly appreciated as to how you secured it.

Secretary DILLON. I will be glad to give you a fuller explanation of the details that went into table 4. I think that table 3 which is just the gross effect rather speaks for itself.

Senator CARLSON. Well, I assure you that would be very helpful if you could.

I have a question or two here on foreign income. It seems to me that we hear a lot of complaint about the proposals in this bill, I am sure every member of the committee has, and I think there are some real concerns about it among people who operate in this field. The first has to do with the supposed benefits in our balance of payments position.

From a study of the testimony before the Ways and Means Committee as I have been able to read, and from comments by others, it would seem that while the immediate effect might be a plus so far as the income flow is concerned, and certainly the long-term effect, and by that I do not mean very long either, inevitably it would be bad.

It would appear to me that this is a short-term prosperity and a long-term proposition that might not be to our advantage. What is your comment on that?

Secretary DILLON. Well, I commented in my statement on that, that it was clear from our analysis of the figures which we have done in great detail over the past 6 months that an investment today in Western Europe, manufacturing in one of these developed countries, would not result in an equal return flow for at least—and this is conservative—10 or 15 years. So that as far as balance of payments is concerned, it will be a negative item for at least that long.

Now, certainly we agree that if the investment is profitable, if it works well over the long term, it should begin to return funds back home and should return enough to offset the outflow, and should be an asset. That is why we believe in foreign investment, and it should be made in years when you have substantial surpluses and it should be there to help you in years when you have deficits in your balance of payments.

The problem now is that we happen to be in a deficit period, and we do not feel this is an appropriate time to try to stimulate further investment by maintaining the tax inducements which have been in our laws for a long time.

I would like to recommend or to ask that you examine this exhibit III, which was prepared with a great deal of care and effort over a period of many months, including some various conferences with business representatives to advise regarding the accuracy and importance of the statistics that are contained therein and the relevance of these statistics. We think that the table in the exhibit clearly answers the problem and is accurate.

Now, many of the statements that were made last summer before the Ways and Means Committee, which were made after our original presentation, did make it appear that this investment was profitable for balance of payments purposes sooner than we think is the case. But the big problem there was that they always compare, every time that I have seen it, the income that is received from investments that have been made over the past 10, 15, 20 years, with the immediate dollar that goes overseas, and actually that is not a relevant comparison.

At the moment, the facts are that we have a total investment overseas of about $50 billion, and we are getting a net return out of that investment—compared to the net against the new investment that has gone overseas—a net return of about $200 million, and that is much too small at this time.

We think this is a time when we should be getting some net benefits in our balance of payments from our investments overseas.

That is why I read some of those statements of the British Chancellor of the Exchequer when they are in a somewhat similar position, and certainly the views that they have are identical, except they go much further than we do. We do not plan to go into the form of planned controls.

Senator CARLSON. Mr. Secrertary, are we not, by this piece of legislation, trying to make investments in foreign countries less attractive?

Secretary DILLON. Most certainly we are, because they have been made more attractive by the special tax benefits which they have had for a long time, and we are trying to make them less attractive to the extent that we remove the special inducements.

We are not trying to make them unattractive so that nobody can invest abroad. Not at all. We think, and I think, most of the businessmen to whom I have talked, the ones who have real substantial operations, would tell you that they do not go abroad just for tax reasons, and they probably will, a great amount of this investment will, continue. But what we want to stop is that which is induced just by tax considerations.

Senator CARLSON. Is there any reason to believe if we do that that these corporations of ours will make greater expanded investments in the United States? After all, they are good business people.

Secretary DILLON. Well, they may or they may not. But certainly that is where the investment credit so closely complements this foreign tax move, because if we make investments in the United States more attractive, and at the same time we are making investments abroad somewhat less attractive, I think the chances are much greater that they will make additional investments here. And what we point out, which is pointed out very clearly again in that exhibit, is if $100 is not invested in Europe because of a change in the tax situation, if only $10 of that amount should be invested here in the United States, the effect on employment and growth in the United States would be equal to or better than the $100 invested in Europe.

Senator CARLSON. Let us assume that this foreign tax credit works. It would seem to me if these provisions were enacted foreign governments could or would tend to raise their taxes on American corporations so that the ultimate effect of these provisions would be to reduce the revenues to the United States rather than increase it. What is your comment on that?

Secretary DILLON. I do not think they would reduce the revenue. I do not think we would get all the revenue back that might be expected on a gross basis, and our figures or our estimates take that into account.

That is why we have estimated a relatively low figure of income for the tax haven provisions in the House bill, which are quite strong provisions, because one of the things that this may do is simply make tax havens less attractive in Europe. Companies may operate more normally in the country in which they are manufacturing, in which their manufacturing concern is located, and pay taxes there, so we will not get the actual tax.

But the tax inducement to go abroad and to make new investments because of these very low taxes will be removed, and we will gain in our balance of payments from this.

Senator CARLSON. The chairman this morning, Mr. Secretary, mentioned our situation with regard to Switzerland and some of our banking operations there.

Just last Thursday, I believe, you appeared before the Senate Foreign Relations Committee in regard to S. 2824, which amends the Bretton Woods Agreements Act, which was to increase our authorization so that the Secretary of the Treasury is authorized to use a public debt transaction not to exceed $2 billion, which greatly expands this program.

I know you expressed your concern about our balance of payments. Is it not reasonable to assume that this legislation we are considering today is most important in our balance of payments rather than in the collection of taxes?

Secretary DILLON. I think that of the two elements involved here in the foreign field, that the most important one probably—it is difficult to say which is the most important one—but vitally important is, first, the balance of payments, as you say; and the other thing that is vitally important is the general principle of tax equity, with respect to the abuse of these foreign tax havens which has become a scandalous thing. It is not that everybody who uses them should be stigmatized that way, but they have been very seriously abused, and that is the second major reason they should be prohibited.

The third reason only is the extra revenue that will be obtained for the Government from that. I do not think it is tremendous compared to our overall revenues. But the balance-of-payments effect of this legislation, the combination of the investment credit and foreign income legislation, I think may be a saving of $300 to $500 million a year in our basic balance-of-payments deficit, which would be a very substantial help in closing this gap, which we simply must close.

Senator CARLSON. I am confident, having heard you before, that you feel that we must close this gap because of its importance to the financial stability not only of our Nation but of the world.

Secretary DILLON. That is correct.

Senator CARLSON. I was interested to read last week a column that appeared in the Evening Star of March 27, 1962, written by Constantine Brown, from Switzerland, at Zurich, and I am not going to quote what he says about it, but I think it is interesting to read what the Swiss bankers are saying about it. This is a quote from Mr. Brown's article. He quotes a direktol—which, I assume, is Swiss for directive—which has been sent out to their bankers, and it is an amazing story to me and one which I think should give us great concern.

I am going to take a little time just to read it. I think it ought to be read into the record, and this is from the Swiss banker, not what Constantine Brown said:

You are still the richest country in the world not only in raw materials but initiative genius, know-how, and daring. But, at the rate of your expenditures for domestic progress, defense and, particularly, your indiscriminate desire to help the rest of the world regardless of its desserts, you will not be able to continue to discharge a self-imposed obligation without serious consequences.

The gold outflow should be a real warning. Your rate of taxation—direct, indirect, and indivisible—has not yet reached the saturation point, but you are not far from it.

Since it is obvious that all your political men are pledged to the continuation of this role of the world's Good Samaritan, I cannot see the end of these expenditures even in the highly problematical circumstances that there may be a lessening of the arms race. You will be compelled by drastic economic necessities to divert the billions you are spending on defense to social work. This means the burdens of taxation will continue.

The outflow of gold—

and these are statements now by a Swiss banker, not some commentator—

is continuing at a more alarming pace than the average American citizen and even your lawmakers realize.

In order to provide the huge amounts needed for social engineering and increased help to the underdeveloped countries which would follow the highly unlikely slowing down of the arms race, you will have to increase the taxation of every American from factory worker to the man living on modest retirement and the coupon clipper. Despite your present efforts, it will be difficult for you to regain your position in the world markets because of the high increasing costs of production.

You will continue, of course, your democratic form of government. But don't forget history. There have been many instances when the tax collector has become more of an oppressor of the people than the secret police in a dictatorship.

In order to gather the necessary funds to continue gigantic, self-imposed tax and credits to the grave, the income tax collector will become more arbitrary and increasingly consider the taxpayer as a lemon which must be squeezed to the last drop and in the long run this will cause you serious trouble.

I wanted to read that into the record because that must be the thinking of some of the top financial people, particularly in Switzerland, or this man would not have written a directive to the banks in Switzerland.

Do you have any comment on this?

Secretary DILLON. Well, one thing there in that thing which somewhat surprises me is the apparent emphasis on the fact that the overall tax burden in the United States is so unusually high.

The fact of the matter is that our overall tax burden, Federal, State, and local in the United States, is less than it is in some six out of seven of the European countries, all of whom are, or over the last 10 years have been, able to bear this tax burden and move ahead economically a great deal faster than we have.

(The following was later received for the record:)

TOTAL TAX COLLECTIONS AS A PERCENT OF GNP AND NATIONAL INCOME, THE UNITED STATES AND FOREIGN COUNTRIES

Following is a table showing total tax collections as a percent of gross national product and national income in 10 countries. The ratio of income and wealth taxes to total taxes and to national income is also shown. This table

is based on data from national account statistics, compiled by the United Nations. The definitions of terms used in the table follow:

(1) Gross national product is equal to the market value of the product before deduction of provisions for the consumption of fixed capital.

(2) National income is the sum of income accruing to factors of production before deduction of direct taxes.

(3) Total taxes shown in the table include indirect and direct taxes on corporations, households, and nonprofit institutions.

(4) Income and wealth taxes include direct taxes on corporations, households, and private nonprofit institutions. Social security contributions of both employers and employees are included in direct taxes. Excluded from income and wealth taxes are taxes on goods and services which are chargeable to business expense, and taxes on the possession or use of goods and services by households. Examples of such taxes are import and export duties, sales taxes, and motor vehicle license fees. Real estate and land taxes are included in indirect taxes (and hence are excluded from income and wealth taxes) unless they are considered administrative devices for the collection of income taxes.

This table shows that the ratio of taxes to GNP and national income is higher in six countries than in the United States. Only in Belgium, Canada, and Japan are taxes a smaller proportion of GNP or national income. The United States, Sweden, and the Netherlands derive the highest proportion of their taxes from income and wealth taxes. The ratio of income and wealth taxes to total taxes in the other seven countries is considerably lower than in the United States.

More significantly, however, Germany has the highest ratio of income and wealth taxes to national income, followed by the Netherlands, Sweden, and the United States. These countries are followed by France, Italy, the United Kingdom, Belgium, Canada, and Japan, in that order.

These rankings differ sharply from those shown in the last two columns of the table, taken from the September 1961 issue of the First National City Bank letter. As the figures in column 9 show, when Central Government tax collections alone are taken into account, the United States has the highest ratio of taxes on income and capital to total tax collections. This country derives 86 percent of tax revenue from these taxes while Canada, the next highest ranking country, derives only 60 percent of tax revenue from the same sources. (Income and profit taxes, death duties, and estate and gift taxes are included in taxes on income and capital.)

The ratios shown here are less significant than those shown in column 8. This is so for two reasons. In the first place, Central Government revenues alone are considered. In the United States, State and local governments rely heavily on indirect taxes while the Central Government relies primarily on direct taxes. In many countries the Central Government collects the indirect taxes levied in this country by local government, as well as individual and corporate income taxes levied primarily by the Central Government in the United States.

Secondly, the comparison of income and capital (or income and wealth) taxes to total taxes is less meaningful than the comparison between those taxes and national income. The former gives no indication of the rate structure of taxes nor of their incidence. The latter shows what proportion of the income earned by factors of production is left to their own disposal. Although taxes on income and wealth as a percent of total taxes are higher in the United States than in West Germany, the ratio of income and wealth taxes to national income is much higher in Germany than in the United States.

Total tax collections as a percent of GNP and national income, 1959 (includes State and local taxes)

Country	Taxes as a percent of GNP	Rank	Taxes as a percent of national income	Rank	Income and wealth taxes as a percent of total taxes	Rank	Income and wealth taxes as a percent of national income	Rank	Taxes on income and capital as percent of Central Government tax revenue [1]	Rank
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Belgium	23.1	9	31.1	9	59.0	4	18.3	8	39	7
Canada	24.3	8	32.0	8	46.7	10	15.0	9	60	2
France	33.3	2	44.2	1	48.2	9	21.3	5	31	8
Germany, Federal Republic	34.0	1	43.9	2	55.3	7	24.2	1	22	10
Italy	[2] 29.2	4	37.2	3	52.1	6	19.4	6	26	9
Japan	19.0	10	23.8	10	49.9	8	11.9	10	51	6
Netherlands	29.1	5	35.4	5	66.5	1	23.5	2	54	3–4
Sweden	29.7	3	[3] 32.6	6	66.0	3	21.5	3–4	53	5
United Kingdom	28.9	6	36.2	4	53.4	5	19.3	7	54	3–4
United States	26.7	7	32.5	7	[4] 66.2	2	21.5	3–4	86	1

NOTES

[1] 1960 data.

[2] In the United Nations source, social security taxes for Italy are not included. They have been added here, estimated by extrapolation from data on social security collections in previous years, given in OEEC, Sources and Uses of Finances, 1948–1958.

[3] Estimates of national income include provisions for the consumption of fixed capital; the total shown therefore relates to gross national product at factor cost rather than national income.

[4] The UN Yearbook of National Account Statistics gives total U.S. tax collections for 1959 as $129,091,000,000. This includes $43,646,000,000 in indirect taxes and $85,445,000,000 in direct taxes. The Survey of Current Business, July 1961, has total tax collections in the United States for 1959 as $124,683,000,000, including $83,000,000,000 of direct taxes and $42,000,000,000 of indirect taxes. Nontax government receipts and Federal grants-in-aid to the States have been omitted from this total. Using the Survey of Current Business figures, total tax collections in the United States are 25.8 percent of gross national product and 32.1 percent of national income. Income and wealth taxes are approximately 66.5 percent of total taxes and 20 percent of national income.

Sources: (1) United Nations, Yearbook of National Account Statistics, 1960; (2) German tax data from Deutsche Bundesbank, Monthly Report, January 1961; (3) Column 9 from First National City Bank, Monthly Letter, September 1961, p. 100.

Office of the Secretary of the Treasury, Office of Tax Analysis, Feb. 8, 1962.

That does not mean to say that all our rates are proper. I am just talking about the overall take—Federal, State, and local.

It is not too high; it is not the highest in the world by a long shot. There are seven, eight, or nine free countries, and they are mostly all the industrialized ones, that actually collect more taxes as a percentage of their gross product than we do here in the United States.

I do think he is entirely right when he talks about the necessity of avoiding inflation and keeping our price level from going up. He mentions there that we will not be able to do that and it will continue to rise. Again the facts are that last year our price level for the first time, although it has been trending in this way for the last 3 or 4 years, stayed practically level, whereas the European price levels all rose and, therefore, we are competitively, as regards price levels, in a better situation vis-a-vis the world than we were a year ago today.

I think that it is very satisfactory that we have the settlement that can generally be classified as noninflationary in the great steel industry, which gives good promise that we are going to continue this situation for the coming year.

But certainly nothing is more important to keep ourselves competitive in the world than to keep our prices competitive, and unless we can do that we will not be able to balance our payments.

Senator CARLSON. I well remember, Mr. Secretary, when you appeared before our committee urging approval of the OECD, and it has been approved by Congress.

Isn't one of the canons of the OECD that undistributed profits of a corporation carrying on business in Switzerland, for instance, they are not to be subject to tax by any other country?

Secretary DILLON. I think that may be so.

As I pointed out, we propose to tax the U.S. shareholders. We do not propose to tax the company in Switzerland.

Senator CARLSON. Mr. Chairman, I am not going to bother the Secretary further with questions. He has stated this morning that this is the first part of the administration's legislative tax program, and that there is a two-part tax reform, and that later this year we are going to get some further recommendations.

I have had more mail, Mr. Chairman, on this Baker-Herlong bill than any other type of legislation before Congress at this time.

I would ask unanimous consent that the provisions of the Baker-Herlong bill, H.R. 2030, be included in the topics for discussion during the hearings on this bill.

The CHAIRMAN. Without objection.

Senator CARLSON. That is all, Mr. Chairman.

Secretary DILLON. There is one thng I would like to add in my final answer about the OECD, Senator. When working bodies of the OECD which look on montary affairs and balance of payments talked about the United States, one of the questions they asked is why the United States allowed the continuation of this specially favorable tax treatment for investments overseas, particularly in Europe. So there certainly will be no problem with these European countries if we adopt legislation of the sort that we are recommending now. In fact, they all think it is long overdue.

The CHAIRMAN. Senator Gore?

Senator GORE. Mr. Secretary, I think you made a very excellent statement on the desirability and necessity for the removing of preferential tax treatment of income earned abroad.

I found only one major disagreement with your statement on that particular subject and that was that the preference should be continued for investment in underdeveloped countries.

Secretary DILLON. To make clear what we meant, we felt we should continue to allow deferral in underdeveloped countries, and we felt we should continue to allow the profits in underdeveloped countries to be moved from one underdeveloped country to another, because we feel that this is of general help in our basic foreign policy. We also feel, based on the figures which you will see in that exhibit III, that investment in manufacturing industries in underdeveloped countries is entirely different from manufacturing investment in developed countries because it relies much more heavily on machinery, spare parts, and the continuing flow from the United States. So it does not hurt our development.

Senator GORE. I am aware of those distinctions, and I am aware, too, as you undoubtedly are, that a larger percentage of foreign investments in the underdeveloped countries are in the extractive industries.

Secretary DILLON. That is right.

Senator GORE. And they operate principally in branch form because of depletion allowances and other provisions which make it more favorable to operate in that form.

Even so, do you think that there is some danger involved in confusing U.S. tax policy with foreign policy objectives which may not be very clearly stated or understood or which may change rapidly with respect to a particular country?

Secretary DILLON. Well, I think there certainly is a general point there that one could have a basic philosophical difference about. I think if we were, the Treasury Department were, doing this purely from tax policy, we probably would agree with you.

But on an overall position of the administration, taking into account the foreign policy objectives and viewpoints of other departments, the decision was reached that it would be advisable to allow this to continue in underdeveloped areas.

Senator GORE. Well, I am sympathetic with the fact that you are part of a team. Even so it seems to me that it would be an act of greater wisdom on the part of the administration to strike out all the tax favoritism for income earned abroad and then pursue its foreign policy objectives with more specific measures, remedies, and programs.

To illustrate the difficulty with which we come face to face, what is the definition of an underdeveloped country?

Secretary DILLON. Well, the only definition we have here is that they are countries that would be so listed by the President, and then the bill specifies certain specific countries which under no circumstances can be classified as underdeveloped, and lists them, and those are the countries of Western Europe, Canada, Japan, Australia, New Zealand, South Africa, and Hong Kong.

Senator GORE. Where would Guinea fall?

Secretary DILLON. Where would Guinea fall?

Senator GORE. Yes. Would that be underdeveloped or overdeveloped?

Secretary DILLON. If you are asking an objective question, that would certainly be underdeveloped. Whether the President would so list it for the purpose of this bill I do not know.

Senator GORE. Well, that illustrates my point, at least one of them. Under the bill there is the widest possible latitude, complete discretion.

Guinea could be declared an undeveloped, underdeveloped country, be listed or unlisted. So could Cuba.

Secretary DILLON. It says this does not apply to Sino-Soviet bloc countries, and I would consider Cuba a member of that.

Senator GORE. Have you declared Cuba to be a part of the Sino-Soviet bloc?

Secretary DILLON. It is as far as I am concerned, and I think it is generally as far as the administration is concerned.

Senator GORE. Well, I will not belabor this point.

Secretary DILLON. The Treasury now applies some of the Trading with the Enemy Act provisions with Cuba as we do with the Sino-Soviet bloc.

Senator GORE. So far as tax policy is concerned, the advisability of it and the equity of it—I think you have responded to that point.

From those standpoints the tax favoritism for operations in underdeveloped countries is not justified.

Secretary DILLON. That is correct.

Senator GORE. I will not pursue that point further. You and I are in substantial agreement.

Now, what is the definition of a controlled foreign corporation in the bill?

Secretary DILLON. The definition of a controlled foreign corporation is one which is owned, over 50 percent of its total stock is owned, by American interests.

Senator GORE. Don't you think that is rather loose? What about 50 percent ownership? What about 49 percent?

Secretary DILLON. Originally we had suggested somewhat tighter definitions. But this was the definition that was agreed upon by the Ways and Means Committee because they felt if you went below 50 percent then the American owner could not control the payment of dividends or the action by the company and, therefore, it was not equitable to subject them to this sort of tax. That was their decision, and we think this answers the greater part of the problem. So it was acceptable to us.

But I think our original proposals were more strict.

Senator GORE. Please understand, Mr. Secretary, that I would be happy to settle, on this particular subject matter, for the recommendations which you have submitted today.

However, since the bill must go to conference, I think it might be the better part of wisdom for the Senate to write the best bill possible, hoping that we might come out with as much as you have recommended today.

Unless the tax deferral problem is treated effectively, then we but piddle with the problem of preferential treatment of foreign income; would you agree with that?

Secretary DILLON. I think that is it. We do hit the tax haven thing fairly well here, but the basic problem is in deferral, and that has not been touched at all.

Senator GORE. Well, the bill deals with tax haven operations on a piecemeal basis. It deals with commissions, with fees, with insurance and reinsurance. But by specifying the particular methods of avoidance about which we now know, and dealing specifically with them, the bill leaves open others that would soon be taken advantage of.

Secretary DILLON. I think so; yes.

Senator GORE. I think the effective, the more direct, way is to deal with tax deferral on an overall basis, and then pursue the foreign policy objectives of the United States in a specific manner. But you and I have no serious difficulty on that so we will agree and maybe have our arguments with somebody else.

You are aware, I am sure, that the mutual savings institutions, the building and loan associations, and other such institutions, feel that they are severely pressed, perhaps not so much by the tax provisions contained in the House-passed bill, as by the action of the Federal Reserve System in permitting commercial banks to increase interest rates on savings to 4 percent.

Secretary DILLON. Well, I heard that, and we have been waiting to see what the results are. I was interested to note that the report

has just come out of the increase in deposits throughout the country in mutual savings banks in the month of February which is at an alltime high increase, the biggest increase which they have ever had in any month, so they do not seem to be hurting very badly.

Senator GORE. What was the increase in savings deposits in commercial banks for that month?

Secretary DILLON. They also had a substantial increase, very substantial. I think in the commercial banks there may have been some regular deposits that were moved over into savings deposits and time deposits.

Senator GORE. At least this has created a severe competitive problem.

Secretary DILLON. That is absolutely correct.

Senator GORE. And one that is almost certain in the long run to increase interest rates which all must pay.

Secretary DILLON. It has not so far.

Senator GORE. I understand.

Secretary DILLON. In the long run it is hard to tell.

Senator GORE. Thank you. I find that I am unable to support your recommendation on the investment credit because I think your position is based upon three fallacious principles or premises, and rather than ask you a series of questions—I have listened all day and made notes of my views after I have listened to you—I shall state these principles and if you wish to respond that would be fine. Perhaps it would be quicker than at this time asking you a long series of questions.

Those three fallacious principles, as I see them, are as follows:

1. The U.S. tax policy should and must conform to tax policies of other industrialized nations. I think this is basically wrong.

The United States, I have conceived, is a leader in the free world economy. You say, let me read from your statement, that—

> it is essential to our competitive position and markets, both here and abroad, that American industry be put on the same basis as foreign industry.

Now, if we do that, we let the plutocrat industrialists, who seem to dominate in West Germany, and the Tory government in England, fix the tax policy of the United States.

If we compete with them in their present preferential tax treatment, then suppose they up us again, must we again meet their standards?

Secretary DILLON. I think that is a very real and difficult problem. I would not say that the European governments are generally all conservative governments, because the government that gives probably the greatest benefits to industry for depreciation is the socialist government of Sweden. So it is a general thing in European tax policy that they do give substantially greater benefits for writeoffs of depreciation than we do.

Now we are in a world that is a competitive world, and the thing I just cannot see is how we are going to compete unless we allow our industry to compete on an even basis with these foreign competitors.

I do not like any more than you having to pass laws or enact provisions because they are the type of provisions that have been enacted somewhere else.

I would like to think that we could operate all by ourselves.

But I just do not feel we are in a vacuum, and I think we are facing a very real competitive situation, and this particularly applies to the question of the choice between investment in this country and investment overseas. It certainly is true that an American company that is able to make that choice gets better treatment if it invests its money overseas than if it invests it here today on this basis.

Senator GORE. You have moved to correct the preferential treatment of income earned abroad by our citizens.

Secretary DILLON. Only part of it; except for the investment credit, which is a very important part, and the treatment of depreciation, we cannot correct that by foreign tax measures. We can only correct that by equalizing opportunities for business here at home with those abroad, because there is no other way of doing it.

Senator GORE. That further illustrates the policy of the treadmill if the U.S. Government undertakes to match tax concessions for business. The Government of West Germany, although I do not ask you to agree with this, pursues a policy under which the mass of the people are underpaid; people underconsume; the profits and the privileges of the the few maximized. Yet this investment credit is advocated on the basis that we must match West Germany, and other European countries.

That leads to the second of what I regard as fallacious premises. You propose to give unjustified benefits to just about all types of business and industry in the United States, the overwhelming proportion of which is not engaged in foreign commerce, and does not make any significant contribution to foreign commerce, on the grounds that such benefits are necessary for U.S. industry to compete internationally.

Now, I will not cite examples. Both Senator Williams and Senator Douglas cited them. I could cite hundreds of them, as I am sure you could, such as elevators in a downtown parking garage.

Yet all these people, the bowling alleys—I said I would not cite more of them—are given this unjustified tax benefit on the basis that the small percentage of our industry and business engaged in international commerce needs tax breaks to compete, because the industrialists of Germany and Sweden and England have such breaks and benefits.

I said I would not ask you a lot of questions.

Secretary DILLON. Shall I comment on that?

Senator GORE. Yes, yes, indeed.

Secretary DILLON. I would say that one of the basic reasons for this proposal, and the reason I gave first, and which I will advert to frequently, is the balance of payments reason. That, of course, applies both to competition abroad in the export field and to competition here in the United States against imports.

It is important, but it is not the only reason. There is another reason which we feel is equally important, which is the reason which is spelled out at some length in the report of the President's Council of Economic Advisers.

We do feel that an increase in investment and the rate of investment is necessary for the economic growth of this country and to solve the problems of growth and unemployment here in this country.

We do feel that this can be brought about—will be brought about—by the investment credit, and in that aspect these other types of investments take on a somewhat different characteristic: Different industries, no matter how unimportant they may be for exports, are vitally important because they give employment and are part of our overall economy here at home. And we do feel that this is an important part of our economic growth.

We pointed out that investment cannot do the trick alone. We have to build up consumer demand at the same time. But we do think that increasing consumer demand just by itself will not be adequate and, therefore, we feel we have to increase the proportion of our investments that goes into capital expenditures. This is necessary to promote full employment, and to promote an adequate rate of growth in this country, helping to solve two great domestic problems that we face economically.

Senator GORE. Well, that leads to the third premise which I regard as fallacious, and that is that you urge more productive capacity when idle capacity, surplus production, and widespread unemployment constitute our most gnawing domestic problem.

If you could cite the lack of productive capacity or if you can cite things that are not in surplus or even—this is not the first time this committee has had this problem. You will remember that your predecessor, Mr. Humphrey, advocated the tax concessions of 1954, and the high interest rate policy on the grounds of shortages.

When asked by, I think, the senior Senator from Oklahoma to cite an example of a commodity that was scarce, the only item he was ever able to cite was steel pipe or gas pipelines, and then Senator Kerr asked him what part that item played in the cost of living.

For these three reasons I am unable to support the investment tax credit, although I regret that is the situation in which I find myself. I would like to support my administration. I do in some regards.

Secretary DILLON. Thank you, Senator.

The only thing I have to say on that last is that we do believe that increased expenditure for capital goods will create employment by itself, and that this is just a question of economic theory. I must say that I am not an economist, I do not pretend to be. But certainly the President's Council of Economic Advisers are very capable. I rely, in this aspect, on their views, which are that this sort of a stimulation to our capital formation will be helpful in solving the unemployment and the growth problems of our country.

Senator GORE. I agree, Mr. Secretary, that this is a question of economic theory. It is also a question of political theory. It is older than either of us. Many people for many years have thought that the way to solve the economic problems of the country was to give better benefits to the few, and that would eventually bring bonanzas to the many.

But there have been an equal number of people, and now and then a few more, who believe that the more broadly the benefits of this society are distributed, the benefits of Government policy flow, the more apt we are to have an equitable distribution of both benefits and enjoyments.

Secretary DILLON. I would agree with that entirely, and we think that this is, as part of the solution to the problem, something which will contribute to that end by reducing prices.

Senator GORE. Then you are merging the two philosophies.

Secretary DILLON. That may be.

Senator GORE. Maybe you are the bridge we have been looking for. [Laughter.]

You said before the Committee at your last appearance that you would be prepared to give the recommendation of the Treasury Department with respect to the tax abuse, as I described it, of restricted stock options. Are you prepared today to do that?

Secretary DILLON. Yes, I am prepared to give our position as of now.

We are preparing, still are working on, a complete statistical basic report on this subject which is not yet ready, but will be before the hearings are completed. And we will be glad to submit that to the Committee in the next few weeks so you will have that. But I am glad to give our overall feeling about this now if you so desire.

Senator GORE. I wish you would.

Secretary DILLON. Well, our view of the matter is that this stock option law, which was passed in 1950, was passed for the purpose of increasing the incentive to the very highest paid managerial elements of our business economy.

Senator GORE. Increasing what did you say?

Secretary DILLON. The incentives for them to work. That was the reason that it was passed.

Senator GORE. Would you call an incentive to work compensation?

Secretary DILLON. Compensation is an incentive to work, yes; I think it is.

Senator GORE. All right.

Secretary DILLON. And because of that it has, I think to some extent, succeeded.

We do think that it is a wrong system, and we think that basically it has no place, no continuing place, in our tax laws.

We basically think that stock that is obtained under options, should be taxed as ordinary income when it is obtained.

However, we do feel——

Senator GORE. That is when the option is exercised?

Secretary DILLON. That is right. It might be spread over some period of average time or not, I am not going that far into detail.

However, it has been our feeling, and it is our feeling, that this particular abuse, this particular thing, could be more fairly and better corrected at the same time as we review the whole income tax structure, and hopefully come up with some substantial reductions in the income taxes up and down the line, as I mentioned this morning in answer to a different question. We think that would be more appropriate.

Since the present bill, as I understand it, which you have suggested, only applies to options issued after this particular date, we would not think that much would be lost by waiting for a year to put this much needed corrective into effect. I think that is our general impression, that probably in the next year and in the immediate years to come the

benefits that flow from stock options, in general, or new stock options, are not likely to be as much as they were in the past 10 years because in the past 10 years there were certainly very great benefits that flowed from the fact that the value of stocks, in general, has pretty nearly tripled compared to earnings. So that even the stock of a company which did no better, is apt to be selling at a price three times as high as its price 10 years ago when an individual would have tripled his benefits as a result of this.

We do not think that sort of phenomenon can continue at the present high prices so that we do not see how the benefits from here on out can be anywhere near as great as they were in the past 10 years.

But we do think on the basis of a very careful study that this is probably not a proper thing in the tax law.

Senator GORE. You put in "probably."

Secretary DILLON. Is not a proper thing.

Senator GORE. Well, you and I are in agreement there except as to whether we should wait to correct it. If this is an abuse that is so clearly recognized and so widely used by corporate insiders to increase their compensation and avoid payment of taxes, then I think the quicker we can strike it out the better.

The SEC report for the month of February 1961 showed more than $23 million worth of stock purchased under options by corporate officers and directors.

For the 5 months up to and including February 1961, almost 1,000 option transactions were reported, involving more than 300 corporations, and I would just like to cite, although I do not ask you to comment on these, for your information, some of the companies and the officials who have received restricted stock options which you have accurately described as additional compensation or incentives.

If it is compensation for work, if it is an incentive for duty, then they should pay regular income tax on that salary, on that compensation, the same as a man who rolls up his sleeves and works 8 hours a day, and I agree with you on that.

Let me cite a few examples: 44,672 shares of General Electric stock were purchased by only 17 officers.

Only six officers of Westinghouse bought 22,960.

The 45,400 shares of Procter & Gamble went into restricted stock options, and who received 15,000 of these? Mr. McElroy who, you may recall, was unable to remain as Secretary of Defense of the United States very long because some of his options were going to expire, as I understand it.

Six officers of U.S. Steel bought 32,300 shares, 12,000 of which were bought by Mr. Blough; 22 officials of General Foods bought 35,270 shares.

This, as you have accurately described, is compensation, and yet no taxes are paid upon this compensation at the time the option is exercised and, indeed, if the stock goes into their estate they never pay any income tax whatsoever.

Let me cite one other example. Mr. Thomas J. Watson, Jr., president of IBM, was given the right of purchasing 7,643 shares of IBM stock in 1956 at $137.70.

The last time I looked at the quotation on IBM stock, the increase in value of these 7,643 shares was a little more than $4,500. Even so, Mr. Watson has received another restricted stock option.

I say that the time to stop this is now. We, unfortunately, may not have a tax reform bill passed next year. The Ways and Means Committee may take as long with that as they have with this one, so I propose to act on this one this year.

Since you and I are in sufficient agreement on that, I believe I will not go any further on that. You might say the wrong thing. [Laughter.]

I might ask the witness too many questions.

I am disappointed that you are not ready to declare yourself with equal unequivocation on percentage depletion.

I wonder if you would think that one would have received a sufficient allowance if in the first year 100 percent of his costs or investment were recovered?

Secretary DILLON. I would say so.

Senator GORE. Well, then, suppose an amendment is proposed to limit the percentage depletion allowance to a recovery of 10 times the investment; what would be the reaction of the Treasury?

Secretary DILLON. I would not like to comment on any particular percentage at this time because we are studying this, and the real problem is what to suggest as a fair corrective in the law. The chances, I am sure, are that there will be some suggestion made, and so I would not like to comment on any particular one at this time.

Senator GORE. Well, I made a study also of the political difficulty of this problem, and if you will notice, if you have noticed, the snickering throughout the room from day to day when any reference is made to this subject, you will realize that this is one of the abuses that tends to bring our whole tax law into public contempt; and this is a dangerous trend.

I find this laughter amusing, but I also find it disturbing. This is one of the great abuses.

You say, and I think properly so, that if a person within 1 year received a 100-percent return of the amount of his costs and investment, that ought to be sufficient. Yet when I asked you your attitude on an amendment that would limit the allowance to recovery of 10 times the amount of the investment, why, you want to study some more, and maybe that is justified.

You wrote me on—I do not believe you dated the letter.

Secretary DILLON. It is a short time ago.

Senator GORE. Just recently in response to a request by me you sent to me a study that the Treasury Department had made, had completed, in 1952. I would like to read one paragraph realizing, of course, the danger of taking things out of context. But this paragraph seems to be a rather complete thought:

In 1952 the surveyed corporations producing oil and gas deducted as expense $241 million of exploration costs and $1,095 million of development costs.

They also had deductions of $118 million for the recovery of remaining costs invested in properties which were abandoned during the year. They were entitled to $58 million of cost-basis depletion deductions. Their total deductions for tax-free recovery of mineral costs were $1,513 million. In addition they deducted excess percentage depletion of $1,273 million, or 84.1 percent of all their recovery deductions.

I just hope that the Treasury will redouble its efforts, that it will take notice of the snickering every time this subject has been men-

tioned, and will give to the committee its recommendations for the correction of this abuse before we complete hearings on this bill.

Thank you, Mr. Chairman.

Senator CARLSON. Mr. Chairman, may I commend the Secretary for taking his time on depletion. The importance of the oil industry to our Nation's economy is such that I think additional time should be had for study.

The CHAIRMAN. I want to congratulate the Secretary on making a very clear and very frank statement on these difficult matters.

I do want to make it clear that in one or two particulars, the Secretary has emphasized the support this bill has, how the country is divided plainly into industry, labor, and farmers.

Is it not true that the AFL-CIO are opposed to the tax credit?

Secretary DILLON. I think that the labor movement would prefer, as the Senator from Tennessee said, to have this question treated by reductions in individual income tax rates rather than by any reductions to help business.

Nevertheless, the AFL-CIO strongly supported the passage of House bill 10650 in the House, the overall bill.

The CHAIRMAN. Are they on record? You say the two big labor organizations——

Secretary DILLON. They supported the bill as a whole.

The CHAIRMAN. Are they on record in opposition to the tax credit?

Secretary DILLON. I think they are. They testified against it in the Ways and Means Committee.

The CHAIRMAN. I want to make clear that position. Now that covers the two largest labor organizations. When you come to industry, the National Association of Manufacturers and the chamber of commerce, U.S. Chamber of Commerce are opposed to it; are they not?

Secretary DILLON. They both testified against it in the Ways and Means Committee. But, as I pointed out, I think very many individual industries and companies have changed their position, and I would be glad to rest on the record of the hearings here before the Senate Finance Committee.

The CHAIRMAN. As the record now stands, the NAM and the chamber of commerce oppose the tax credit; is that right?

Secretary DILLON. That is correct. I said that. I think there are a great many businesses which will testify in support of it before your committee before your hearings are over.

The CHAIRMAN. When it comes to the farmers, the American Farm Bureau and the Farmers Union are opposed to it; are they not?

Secretary DILLON. I think that is correct.

The CHAIRMAN. That is a pretty big bloc.

Just one other insertion I want to make, and I am not asking you to reply to this because you probably want to study it some.

The impression has been conveyed here, especially to me, that this tax credit is a panacea for the promotion and progress, and so forth, of the country.

Isn't it true that there is only one country, and that is the Netherlands, that has a straight investment credit deduction?

Secretary DILLON. Well, three countries, the United Kingdom, Belgium, and the Netherlands have a deduction over and above 100

percent of cost, and they, I think, all do it in the form of deductions before profits are figured.

The CHAIRMAN. Isn't it true with respect to Belgium that the tax credit is an offset to depreciation?

Secretary DILLON. No. It is over and above depreciation.

The CHAIRMAN. Then the staff has advised me incorrectly.

Secretary DILLON. I think the staff is in error on that if that is what they said.

The CHAIRMAN. Isn't it likewise true that the following countries named have no investment credits: Canada, West Germany, France, Italy, Austria, Denmark, and Japan?

Secretary DILLON. They have other methods, as I pointed out. They usually use highly accelerated depreciation, special initial allowances.

The CHAIRMAN. But it is not a tax credit such as you refer to.

Secretary DILLON. And various other methods. I pointed out there are various other methods that have the same objective, but these other methods cost the Government more in revenue.

The CHAIRMAN. The difference between a tax credit and depreciation, I know the Secretary understands that. There is a considerable difference.

Here is what the staff says about the United Kingdom. In the United Kingdom there are selected incentives which, for the most part, have counterparts in our existing law. For example, there is an incentive of 40 percent for ship construction. We pay 50 percent of the cost of U.S. flag vessels.

The British provide an incentive of 20 percent of the cost of mining equipment. We give the taxpayer a percentage depletion.

The British provide an incentive of 20 percent for scientific research assets. We allow the taxpayer to deduct the cost of research and development in full.

The British provide a percentage allowance of 20 percent for machinery and equipment, but, for the most part, the useful lives are much longer than ours.

I simply want to point out these other countries do not regard a tax credit in itself as a panacea for the troubles we are having here, I imagine, all over the world. If the staff is incorrect in this, I will be glad to open up the record.

Secretary DILLON. No; I think the staff is correct. They pointed out the main thing which is that in the United Kingdom the plant and machinery except a few special ones are given an investment allowance over and above 100 percent of depreciation, or of 20 percent which is the equivalent of a 10 percent investment credit at a 50 percent tax rate, which is about the tax rate in the United Kingdom.

So they are somewhat more generous than what we are suggesting for plant and equipment; and they use the identical method that we are suggesting. So I think that the staff figures are perfectly correct, and they just bear out what we have been saying.

The CHAIRMAN. Now, Mr. Secretary, I have got three other questions which I am going to hand to you, and they are technical, and I will ask you to reply to me as chairman and I will insert them in the record.

(The questions and answers referred to follow:)

INVESTMENT CREDIT

Question 1. Mr. Secretary, your original recommendation based the investment credit on true expansion; that is, the credit was limited to the excess of new investment over the depreciation for the year. Why do you now favor a flat credit which abandons this approach and results in a direct subsidy without regard to expansion?

Answer 1. The flat investment credit adopted in the House bill represents an acceptable modification of the original recommendation for a graduated credit related to investment above depreciation. The across-the-board approach contained in the House bill was worked out after careful consideration of the advantages and disadvantages of alternative procedures. For many firms, the flat credit based on all eligible expenditures will result in approximately the same amount of benefit as a higher graduated credit limited to the excess of expenditures above a specified level. On the other hand, the credit based on investment in excess of depreciation would produce substantially less benefit for industries and companies that have high depreciation charges relative to their investment expenditures. The across-the-board approach also avoids the difficult and complex administrative and compliance problems involved in the "excess" method. These difficulties were extensively mentioned by various witnesses before the Ways and Means Committee.

Question 2. Mr. Secretary, since the credit goes only to those who have sufficient tax liability, doesn't it reverse the philosophy of the administration that equal incomes should bear equal taxes?

Answer 2. Like any incentive provision under the tax laws, the investment credit would be available only to the extent the business had taxable income and tax liability to absorb the credit. It is impossible to provide tax incentives for those with no tax liability. The credit applies uniformly to those firms making expenditures on qualified types of machinery and equipment.

The credit, like accelerated depreciation or other special incentives for investment in productive equipment, will result in benefits geared to the amount of such investment. In other areas of the tax law, such as the deduction for cheritable contributions, the benefits are similarly related to the amount of expenditures which the tax allowance is designed to assist and encourage. The resulting benefits, which will necessarily reflect the varying levels of eligible expenditures by different taxpayers, will not necessarily be proportionate to the taxable income determined without regard to the incentive allowance.

The investment credit is not designed to provide tax reduction for its own sake. Rather, it is specifically proposed to provide needed stimulation to a vital form of economic activity, modernization of machinery and equipment.

To the extent that the question is concerned with the fact that the credit would apply as a subtraction from tax rather than as a deduction from income, this technical distinction does not imply an essential difference in its operation from other incentive features of our tax law.

INVESTMENT CREDIT

Question 3. Mr. Secretary, I would like to analyze for a moment the effect of the 5-year carry forward of the investment credit where because of the limitation it cannot be used in the year the investment is made.

If, and to the extent, this credit which is carried over can be used in subsequent years, doesn't this mean that the limitation does not reduce the revenue loss?

To the extent the carried over credit cannot be used in subsequent years, doesn't this remove any incentive for further investment in these subsequent years?

Answer 3. The 5-year carry forward of unused credit will maintain the intended incentive effect of the credit even though a firm's equipment expenditures or its taxable income fluctuate from year to year. To the extent that the carry forward can be used in future years, it will postpone rather than eliminate revenue loss. Its impact on revenue will be most important in the first year of the credit's operation. However, the carry forward does not set aside the intended effect of the limitation in insuring that the credit will not permit a taxpayer to wipe out his tax liability or escape making a reasonable contribution to the Nation's revenues. It will have a continuing effect in reducing the

revenue cost of the credit. As some corporations carry the additional unused credit forward to be applied against the tax liability in future years, other corporations with unusually large investment programs or lower than average profits and tax liabilities in those future years will find their current credits reduced by the lower limit. This balancing effect will result in a continuing deferment of revenue impact of the credit without actual loss of incentive. In addition, those corporations with a continuing high ratio of investment to tax liability will never be in position to take full (or perhaps even any) advantage of the carry forward. These firms—necessarily large in view of the dollar amount of the limitation involved, and frequently benefitting from existing favorable tax provisions—will receive less credit in the long run and therefore their incentive to invest will be correspondingly reduced. However, the lowering of the limit in this area is likely to have less significant effect on investment decisions than a general reduction in the rate of the credit, which would affect all businesses.

Our recommendation that the limit on the credit in excess of $25,000 of tax liability be raised to 50 percent from the 25-percent figure in the bill after the first year is designed to cope with this very problem and to provide a maximum stimulus to investment consistent with our revenue needs when the revenue gaining provisions of the bill have become fully effective. We recommend the retention of the 25-percent limit for calendar year 1962 solely because it will reduce the revenue impact of the credit during fiscal 1963 when the revenue gaining provisions of the bill are not as yet making their full contribution.

The CHAIRMAN. Thank you very much. You made a very good witness.

(Whereupon, at 5:25 p.m., the committee was recessed, to reconvene at 10 a.m., Tuesday, April 3, 1962.)