Calendar No. 1843

87TH CONGRESS 2d Session | SENATE | REPORT No. 1881

REVENUE ACT OF 1962

REPORT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

TO ACCOMPANY

H.R. 10650

A BILL 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

TOGETHER WITH

INDIVIDUAL, ADDITIONAL, DISSENTING, SUPPLEMENTAL AND MINORITY VIEWS

AUGUST 16 (legislative day, August 15), 1962.—Ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE

87490 WASHINGTON : 1962

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington 25, D.C. - Price $1.25

CONTENTS

If contents for technical explanation of the bill, see page 137.

Calendar No. 1843

87TH CONGRESS } SENATE { REPORT
2d Session } { No. 1881

REVENUE ACT OF 1962

AUGUST 16 (legislative day, AUGUST 15), 1962.—Ordered to be printed

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

REPORT

together with

INDIVIDUAL, ADDITIONAL, DISSENTING, SUPPLEMENTAL AND MINORITY VIEWS

[To accompany H.R. 10650]

The Committee on Finance, to whom was referred the bill (H.R. 10650) 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, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. GENERAL STATEMENT

This bill, H.R. 10650, represents a major revision and reform of our Federal tax system. This is a matter which has been under consideration by Congress since April 20, 1961, when the President sent up his tax message. Most of his recommendations, modified as the House and your committee believe desirable, are incorporated in the amended bill reported by your committee.

The bill contains three principal groupings of tax revision measures. The central element in the bill is the investment credit. This allows a 7-percent credit against tax for most taxpayers for their purchases of machinery and equipment and certain other property (not including buildings). This investment credit, coupled with the depreciation guidelines recently liberalized by the administration, by stimulating capital formation will provide growth in the economy consistent with the principles of a free economy. This investment credit, by encouraging the modernization and expanded use of capital equipment, will improve our competitive position abroad and thus aid in meeting the balance-of-payments problem. Moreover, the capital formation induced by this credit will both aid in providing the longrun growth needed by our domestic economy and be of major assistance in our more immediate problem of economic recovery.

The remaining provisions in the bill are concerned primarily with improving tax equity and eliminating tax evasion or avoidance, either in the domestic economy or with respect to income earned abroad by American interests. In the latter case, the primary concern of your committee has been with the removal of special tax advantages accruing to "tax havens."

One of the measures in the House bill, designed to decrease tax evasion (whether or not deliberate) was a provision for withholding on dividends, interest, and patronage dividends. Because of both the burden of such a provision on individuals owing little or no tax and its many complexities, your committee has deleted it, but has added a requirement for the reporting of payments of dividends, interest, and patronage dividends exceeding $10 annually per recipient, both to the Government and to the recipient. Your committee believes that in the long run this will have at least as great an impact on tax evasion as a withholding system.

Both the bill as passed by the House and as amended by your committee reduce tax avoidance by providing ordinary income treatment for gains from the sale of depreciable property to the extent of depreciation taken. Moreover, by preventing the conversion of ordinary income into capital gains this has been an important factor in making the new liberalized depreciation guidelines feasible.

Among the more publicized and troublesome problems with which the bill is concerned is the deduction for entertainment expenses. Your committee believes that its version of this provision provides a balanced approach which neither prevents deductions for legitimate entertainment expenditures nor permits them for the continuation of abuse situations.

Your committee's bill also is concerned with competitive advantages of specific groups of taxpayers. In this regard your committee, in general agreement with the House, concluded that the reserve deductions of mutual savings banks and savings and loan associations are too large and should be reduced, that mutual insurance companies should be taxed not only on investment income but on their underwriting gains as well, and that in the case of cooperatives a full tax should be paid currently at either the level of the cooperative or at that of the patron.

In the case of foreign income, your committee has been primarily concerned with ending tax haven abuses; namely, devices to avoid either the United States or foreign taxes which could be expected to be imposed under normal business operating conditions. To achieve this goal the bill ends the deferral of the U.S. tax in the case of certain forms of income arising from insurance abroad of U.S. risks, from passive investments, from sales and service subsidiaries separately incorporated from the producing companies, and from funds which are brought back to this country without the payment of U.S. tax. A number of other measures dealing with foreign income or property are also included. Provision is made for the payment of a full 52-percent tax through a "gross-up" procedure when income is brought back to the United States from a foreign subsidiary; for the taxation of income at ordinary income tax rates when controlled foreign corporations are liquidated or the stock interests sold; and for the full taxation by the United States of income distributed to American beneficiaries by foreign trusts set up by American grantors. In addition, a ceiling has been placed on the earned income exclusion for Americans who are residents abroad; and foreign real property holdings are to be included in the estate tax base of U.S. citizens.

Your committee began hearings on this bill on April 2 of this year. These hearings extended until July 3 and included 29 days on which testimony was heard. This material is contained in 12 volumes of nearly 5,000 printed pages. In addition, your committee has considered this bill in executive session for a period of several weeks. The bill, therefore, represents decisions reached by your committee after careful deliberation over an extended period of time.

A. Summary

The provisions contained in the bill as amended by your committee can be summarized by section numbers as follows:

(1) The act is to be cited as the "Revenue Act of 1962."

(2) An investment credit against tax liability is provided. Generally it is 7 percent of investments in new tangible personal property and certain other depreciable property, excluding buildings. A credit also is available for limited amounts of investments in used property. The taxpayer's depreciation base for tax purposes is to be reduced by the amount of the investment credit.

(3) A deduction is provided for expenses relating to appearances before, and communications with, a legislative body, a legislative committee or individual legislator, if the expenses are otherwise ordinary and necessary business expenses. Also included are expenses of communications between an organization and its members and between a business and its employees or stockholders. This provision does not cover advertising expenses or those concerned with political campaigns.

(4) Deductible expenses for entertainment, amusement or recreation generally are limited to those directly related to, or associated with, the active conduct of a trade or business. In the case of expenses related to facilities, to be deductible they must also be used primarily for the furtherance of the taxpayer's trade or business. Limitations are provided in the case of traveling expenses and business gifts. In addition, rules are set forth providing that deduction of entertainment, etc., expenses will be denied unless substantiated.

(5) Distributions in kind from foreign corporations to corporate stockholders are treated as having a value equal to their fair market value (rather than the adjusted basis of the property), and the foreign tax credit available likewise is based on the fair market value of the property.

(6) The present tax treatment of mutual savings banks, savings and loan associations, etc., is revised so that their additions to bad debt reserves generally may not exceed 60 percent of their taxable income (before this deduction) or, if larger, an amount bringing their reserves up to 3 percent of loans on real property. Certain other limitations are also provided, and in the case of stock savings and loan associations the deduction is to be 50 percent instead of 60 percent of taxable income. In addition, a new definition of domestic savings and loan associations is provided and certain excise tax exemptions these organizations presently enjoy are removed.

(7) Distributions of accumulated income by foreign trusts, to the extent the trust was established or added to by American grantors, are to be taxed to the U.S. beneficiaries in substantially the same manner as if they had received this income directly instead of through the intermediary of a foreign trust.

(8) Mutual fire and casualty insurance companies are to be taxed on their "total" income less a deduction for loss reserves equal to one-fourth of their underwriting gain plus 1 percent of their insurance claims. Most of this reserve, to the extent not used to offset losses, at the end of 5 years is to be brought back into the company's tax base. Exemptions are provided for small companies whose total receipts do not exceed $150,000, while those whose total receipts are between $150,000 and $600,000 are taxed on investment income but not underwriting gain. The bill also deals with the special problems of reciprocal underwriters and interinsurers, of factory mutual insurance companies, of mutual marine insurance companies, and of companies whose risks such as windstorm, hail, or flood insurance are concentrated in a relatively small geographical area.

(9) Where a domestic corporation receives dividends from a foreign corporation, the amount included in its tax base, if it elects the foreign tax credit, is to be not only the dividend itself, but also the tax paid by the foreign corporation as well. This provision is not to apply with respect to dividends received from "less developed country corporations" or from certain holding companies for such corporations.

(10) The foreign tax credit limitation for certain interest income is to be computed separately from the limitation for other types of income. The interest income referred to here does not include that derived from the active conduct of a trade or business, from a banking or similar business, or from a corporation in which the taxpayer has a 10-percent voting interest.

(11) The unlimited exclusion from U.S. tax for income earned abroad by U.S. citizens who are bona fide foreign residents is reduced to $35,000 ($20,000 for the first 3 years). However, in applying this ceiling, certain fringe benefits will be gradually taken into account for purposes of this limitation over a 4-year period. In addition, the contributions which employers make hereafter toward employee pension plans, based on foreign employment, will be taxable to the employee when received.

(12) Shareholders of controlled foreign corporations are to report for tax purposes the undistributed earnings of these corporations to the extent they represent income from insuring U.S. risks, increases in earnings invested in U.S. property (generally not related to foreign business), passive investment income, and income from sales or service subsidiaries involving transactions with related persons outside of the country of incorporation of the subsidiary. Dividend and interest income derived from 10-percent-related corporations actively doing business in less developed countries and reinvested in such countries, however, is excluded from the amount taxed to the U.S. shareholders. The bill also provides that if certain minimum amounts of income are distributed (which vary in accordance with effective foreign tax rates) the shareholders are not to be taxed on the undistributed income. In addition, export trade income of "export trade corporations" within certain limits is not to be taxed to U.S. shareholders in the case of most of the categories of income described above. Other relief provisions are also provided.

(13) Any gain after 1962 on the sale of personal property and most other tangible property, other than buildings and structural components, to the extent of depreciation taken in 1962 and subsequent years, is to be treated as ordinary income for tax purposes.

(14) When stock in foreign investment companies is sold, the gain realized by U.S. shareholders is to be ordinary income to the extent of the earnings and profits accumulated since 1962. The companies and shareholders can avoid this treatment if the companies distribute currently 90 percent or more of their taxable income, other than capital gains, and the shareholders report the capital gains, whether distributed or not. In addition, until January 1, 1964, where certain conditions are met, these corporations are permitted to reincorporate as domestic corporations on a tax-free basis without obtaining prior clearance for the reorganization from the Internal Revenue Service.

(15) Where stock in a controlled foreign corporation is redeemed, such a corporation is liquidated, or the stock of such a corporation is sold, any gain realized which represents earnings and profits accumulated after 1962 is to be taxed to 10-percent-U.S.-shareholders as ordinary income. If the shareholder is an individual, his tax on this income is to be no greater than if the foreign corporation were a domestic corporation which paid the 52-percent U.S. tax (offset by any foreign tax credits) and then made a distribution of the balance to the U.S. shareholder who then is subject to a capital gains tax. (The combined tax in this case cannot exceed 64 percent.) Alternatively, the individual shareholder will not have to pay a total tax greater than the sum of the taxes he would have paid had he received the earnings and profits in the years actually earned.

(16) Gain from the sale or exchange after 1962 of a patent, invention, model or design, copyright, secret formula or process, or other similar property by a U.S. person to a foreign corporation which it controls is to be treated as ordinary income rather than capital gain. This does not apply where the transfer is to a controlled foreign corporation for use in its own manufacturing operations.

(17) Cooperatives are to receive a deduction for patronage dividends paid to the patrons in cash or by allocations if the patron has the option to redeem the allocations in cash during a 90-day period after issuance, or consents to treating this income as constructively received and reinvested in the cooperative. The patron may give his consent individually in writing, the cooperative may by its bylaws require members to give this consent, or patrons may give their consent by endorsing a check representing at least 20 percent of the total patronage dividend. For any allocation to be deductible to the cooperative, however, at least 20 percent of the patronage dividend must be paid in cash. Any of these amounts which are deductible to the cooperative must be included in the income of the patron for tax purposes when received if the amounts arise from business activity of the patron.

(18) Real estate located outside 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 estate tax imposed at the time of death.

(19) Payors of interest, dividends, and patronage dividends of more than $10 per year per person must report these payments to the Government on an annual basis and also send a statement to the dividend, patronage dividend, or interest recipient indicating the annual amount so reported. Civil penalties of $10 per statement or information re-

turn are specified for each failure, other than for reasonable cause, to send the statement or information return to the recipient or to the Government. However, the aggregate penalty per payor is not to exceed $25,000 per year with respect to returns to the Government or $25,000 with respect to statements to recipients.

(20) A number of changes are made in the annual information return which domestic corporations presently are required to file with respect to foreign corporations which they control. In addition, a number of changes have been made in the return which must be filed by U.S. citizens or residents who are officers or directors of a foreign corporation and also by 5-percent shareholders of such corporations. Not only is information required to be submitted by those who are officers, directors, or 5-percent U.S. shareholders within 60 days of the organization or reorganization of the corporation but also those who presently are, or subsequently become, officers or directors or 5-percent U.S. shareholders. In the case of officers or directors, the only information required to be furnished is the names and addresses of 5-percent U.S. shareholders.

(21) In the case of farmers, expenditures incurred in the clearing of land may be deducted to the extent of $5,000 or 25 percent of the taxable income from farming for the year, whichever is the lesser.

(22) When an individual is entitled in effect to spread his income for tax purposes back over the years to which it is attributable, he may also elect to apply the 20- or 30-percent limitation on charitable contributions before the income is spread.

(23) The provision in present law which treats a husband and wife as one shareholder in the case of community property and property held as joint tenants, tenants by the entirety, or tenants in common for purposes of the election for certain small business corporations to have their income taxed directly to their shareholders is to be made effective, if the taxpayers so elect, with respect to taxable years beginning after December 31, 1957, instead of 1959.

(24) Net operating losses incurred in 1953 and 1954 by a street railway company in converting from streetcar to bus service, which are not absorbed in the normal carryover period, are to be treated as a net loss occurring in 1959. This permits these losses to be carried forward to the years 1960 through 1964.

(25) The union-negotiated pension plan of Local Union No. 435 of the International Hod Carriers' Building and Common Laborers' Union of America is to be treated as a qualified tax-exempt trust for the period from May 1, 1960, to April 20, 1961, if the trust was not operated during this period in a manner to jeopardize the interests of its beneficiaries. This also permits employers to deduct contributions made to the trust in this period.

(26) The 1939 code is amended to provide that where one partner in a two-man partnership dies, the partnership year for the surviving partner is not to close prior to the time the partnership year would have closed had neither partner died or otherwise disposed of his interest.

(27) No provision in the bill is to apply in any case where its application would be contrary to any treaty obligation of the United States.

B. Revenue estimates

1. Estimates of the Joint Committee Staff.—As indicated in the tables below, the staff of the Joint Committee on Internal Revenue Taxation has estimated your committee's bill will result in a revenue loss of $555 million on a full-year basis, based upon income levels for the calendar year 1962.[1] This can be compared with an estimated loss of $285 million under the House bill on a full-year basis.

For the fiscal year 1963 (July 1, 1962, to June 30, 1963, inclusive), the staff estimates that your committee's bill will result in a revenue loss of $630 million as contrasted to a loss under the House bill for that year of $1,090 million. None of these estimates takes into account any possible effect of the provisions on economic conditions. Table 1 shows the details of the staff's estimates of the effect of your committee's amendments as compared with the House bill on a full-year basis. Table 2 shows the details of the estimates for the fiscal year 1963.

As indicated in table 1, the version of the investment credit provided by your committee's amendments is expected by the staff to result in a full-year revenue loss of $1,340 million. The other provisions of the bill, on a full-year basis, are expected to raise revenues by $785 million, resulting in the net loss of $555 million. Under the House bill the full-year loss from the investment credit was $55 million more than under your committee's action. However, the additional revenue derived from the other provisions under the House bill would have amounted to $1,110 million, which accounts for the smaller revenue loss. Most of the revenue difference in these other provisions between your committee's and the House version of the bill is attributable to the substitution of reporting for withholding on dividend and interest payments. Other differences are the revenue gain from mutual savings banks, etc., under your committee's bill (largely as a result of the amendment affecting stock companies), the decreases in revenue resulting from changes made by your committee in the provisions relating to entertainment, ordinary income on depreciable property, and the "gross-up" of dividends received from foreign corporations. The entertainment provisions are somewhat less restrictive under your committee's bill than under the House bill. In the case of the provision relating to ordinary income on depreciable property the revenue loss is attributable to the change for mining companies made in the method of computing "taxable income from the property" in the case of depreciable property. In the case of the "gross-up" provision, the lesser revenue under your committee's action can be attributed to the fact that this provision is made inapplicable to income from less developed country corporations. Other provisions added by your committee also are expected to result in a $5 million revenue loss. The most significant item here is the deduction allowed farmers for clearing land. There are, of course, also differences within the various other provisions but the losses and gains involved approximately offset each other.

[1] The various provisions, of course, will not have uniform effect in future years. In the case of mutual fire and casualty insurance companies, for example, the full year revenue effect will not be reached until after an elapse of 5 years when most of what remains in the protection against loss account begins to be restored to taxable income. On the other hand, the method of charging losses in the case of dividend-paying companies may reduce tax liability in the fourth or fifth year by as much as $5 million but this will be largely offset in later years when the amounts added to this account are restored to income.

As indicated in table 2, your committee's action according to the staff's estimates results in a revenue loss of $630 million in the fiscal year as contrasted to the $1,090 million under the House bill. Most of this difference is attributable to your committee's action in making the investment credit effective only with respect to acquisitions or construction after June 30, 1962, instead of January 1, 1962, as provided by the House bill. Other differences with respect to the fiscal year 1963 estimates between your committee's action and the House bill are largely attributable to the fact that the reporting of dividends and interest is not expected to have a revenue effect until after the end of the fiscal year 1963, while part of the revenue impact from withholding would have been felt during the last half of the fiscal year 1963. The remaining difference between the two versions of the bill is attributable to the fact that the House bill would have made the entertainment provisions effective as of July 1, 1962, while under your committee's action these are not effective until January 1, 1963.

TABLE 1.—*Estimated full-year revenue effect of H.R. 10650 [1] as passed by the House and as amended by the Senate Committee on Finance*

[Millions of dollars]

	As passed by the House	As amended by the Committee on Finance
Investment tax credit	−1,395	−1,340
Withholding on dividends and interest	+550	
Reporting of dividend and interest payments		+275
Mutual banks and savings and loan associations	[2] +170	[2] +180
Entertainment, etc., expenses	+125	+85
Capital gains on depreciable property	+110	+105
Mutual fire and casualty companies	[3] +25	[3] +25
Cooperatives	+30	+30
Foreign items:		
Controlled foreign corporations	+50	+50
Gross-up of dividends	+25	+15
All other foreign items	+25	+25
Other (secs. 21-26 of Senate Finance Committee bill)		−5
Total	−285	−555

[1] At levels of income and investment estimated for the calendar year 1962, without taking into account effect of provisions on the economy; estimates are rounded to nearest $5,000,000.

[2] The level of income for these thrift institutions in 1962 has been revised upward since the preparation of the revenue estimates for the House bill.

[3] Revenue gain which would result if this provision were in effect for 1962 and had been in effect for the 5 preceding years, so that amounts added to the protection against loss account in the first year and not offset by losses would be brought into taxable income in 1962.

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

TABLE 2.—*Estimated revenue effect of H.R. 10650 for the fiscal year 1963 as passed by the House and as amended by the Senate Committee on Finance*

[Millions of dollars]

	As passed by the House [1]	As amended by the Committee on Finance [1]
Investment tax credit	−1,340	−650
Withholding on dividends and interest	+170	
Reporting of dividend and interest payments		0
Mutual banks and savings and loan associations	+10	+10
Entertainment, etc., expenses	+60	+(2)
Capital gains on depreciable property	0	0
Mutual fire and casualty companies	0	0
Cooperatives	0	0
Foreign items:		
Controlled foreign corporations	0	0
Gross-up of dividends	0	0
All other foreign items	+10	+10
Other (secs. 21–26 of Senate Finance Committee bill)		−(2)
Total	−1,090	−630

[1] Estimates are rounded to nearest $5,000,000.
[2] Less than $2,500,000.

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

2. Estimates of the Treasury Department.—As shown in table 3, the Treasury Department has estimated that your committee's bill will result in a revenue loss of $210 million on a full-year basis, if no effect is given to the stimulative effect of the bill. With this effect taken into account the loss is expected to be only $15 million. These estimates can be compared with the Treasury Department's full-year estimates for the House bill, which show an increase in revenues of $325 million without taking into account the stimulative effect of the bill and $430 million if account is taken of this factor.

Table 3 also shows the Treasury Department's estimate of the effect of the bill in the fiscal year 1963. In that year the estimate is expected to result in a revenue decrease of $485 million without taking into account the stimulative effect of the bill and $210 million decrease with this effect. Under the House bill the estimated effect in the fiscal year 1963 would be a $325 million increase in revenues without the stimulative effect and $430 million increase with this effect.

The stimulative effect of the investment credit under the Treasury Department's estimates is based upon statistical relationships in past years between investment and gradual changes in the cost of capital goods (profit ability) and cash flow. This does not take into account the especially favorable impact on businessmen's decisions to invest or the sudden improvement in these factors resulting from the enactment of the credit.

TABLE 3.—*Estimated revenue effect of H.R. 10650 as amended by the Senate Finance Committee*

[In millions of dollars]

	As passed by House of Representatives				As amended by Senate Finance Committee			
	Full year		Fiscal year 1963		Full year		Fiscal year 1963	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Investment tax credit [1]	−1,105	−555	−1,040	−525	−1,020	−580	−520	−235
Capital gains on depreciable property	+100	+50			+100	+50		
Withholding on dividends and interest	+780	+520	+245	+235	[2] +240	[2] +155		
Expense accounts	+125	+80	+65	+40	+60	+40	+30	+20
Mutual savings banks and savings and loan associations	+200	+135			+205	+140		
Mutual fire and casualty companies	+40	+25			+35	+20		
Cooperatives	+35	+25			+35	+25		
Foreign items:								
Controlled foreign corporations	+85	+85			+85	+85		
Gross-up of dividends	+35	+35			+25	+25		
All other foreign items	+30	+30	+5	+5	+30	+30	+5	+5
Miscellaneous provisions					−5	−5	0	0
Total	+325	+430	−725	−245	−210	−15	−485	−210

[1] At levels of income and investment estimated for 1962; modified from published estimates because of current results of the Commerce-SEC survey of planned capital expenditures. In estimating the net revenue cost of the investment credit, its favorable effects on the level of investment were computed from statistical relationships in the 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 than those shown in the table.

[2] Estimated gain from increased compliance because of reporting requirements.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Aug. 13, 1962.

II. INVESTMENT CREDIT

(Sec. 2 of the bill and secs. 38, 46–48, and 181 of the code)

A. *Reasons for provision*

The Secretary of the Treasury in his appearance before your committee stated:

> The central element in the bill is the tax credit for investment in depreciable machinery and equipment.

At another point he said, with respect to the investment credit:

> 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 Secretary pointed out that American industry today 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. An increase in efficiency and productivity at a rate at least equal to that of other leading industrial nations is in the long run necessary, therefore, both from the standpoint of the U.S. balance-of-payments position and to continue to improve our standard of living. The investment credit as a form of investment stimulation already is in use by the United Kingom, Belgium, and the Netherlands, and is in the process of being enacted by the Australian Parliment.

To achieve an increased rate of capital formation, a two-pronged course of action is being followed in the area of capital formation. First, the Treasury Department has recently announced a series of depreciation revisions. The objective of these revisions is to provide realistic tax lives in light of past actual practices and present and foreseeable technological innovations and other factors affecting obsolescence. The new guideline lives are expected initially to result in an annual revenue reduction of $1.5 billion and to reduce depreciable lives in the case of corporations surveyed by 21 percent. Another facet of this objective is to achieve a more simple and flexible system of depreciation through the use of guideline lives for broad classes of assets used by each of the industries in our economy.

Realistic depreciation alone, however, is not enough to provide the essential economic growth. In addition, a specific incentive must be provided if a higher rate of growth is to be achieved. The investment credit will stimulate investment, first by reducing the net cost of acquiring depreciable assets, which in turn increases the rate of return after taxes arising from their acquisition. Second, investment decisions are also influenced by the availability of funds. The credit by increasing the flow of cash available for investment, will stimulate investment. The increased cash flow will be particularly important for new and smaller firms which do not have ready access to the capital markets. Third, the credit can be expected to stimulate investments through a reduction in the "payoff" period for investment in a particular asset. This reduction in risk, coupled with the higher rate of profitability and increased cash flow, will lower the level at which decisions to invest are made and will help to restore to past levels the proportion of the annual national output devoted, through investment in machinery and equipment, to capital formation.

The objective of the investment credit is to encourage modernization and expansion of the Nation's productive facilities and thereby improve the economic potential of the country, with a resultant increase in job opportunities and betterment of our competitive position in the world economy. The objective of the credit is to reduce the net cost of acquiring new equipment; this will have the effect of increasing the earnings of new facilities over their productive lives and increasing the profitability of productive investment. It is your committee's intent that the financial assistance represented by the credit should itself be used for new investment, thereby further advancing the economy. Only in this way will the investment credit fully serve the overall national interest in greater productivity, a healthy and sustained economic growth, and a better balance in international payments.

Some have suggested that tax changes designed to add to consumer demand are the appropriate way to raise the level of investment. However, to rely only on such an approach suggests primarily expansion of existing kinds of equipment and techniques, rather than more efficient and larger quantities of capital per worker and therefore greater productivity. The credit adds to the quantity and quality of capital available per worker, and increases the relative attractiveness of investment at home compared with investment abroad.

Finally, the statement sometimes made that the credit is a subsidy overlooks the fact that other alternatives, such as faster depreciation, for example, share the same characteristics of giving the investor in equipment a monetary reward beyond what he would receive on the basis of realistic accounting. The credit, however, is preferable to higher depreciation charges because the latter tend to distort income accounting and produce higher costs for book purposes, which frequently could be expected to be reflected in higher product prices.

B. Comparison of committee amendments with House provision

Your committee has retained the basic House provision on the investment credit. As in the House bill, the credit generally allowable is 7 percent of the investment (3 percent in the case of certain public utilities) and this amount may be offset in full against tax liability up to $25,000, and against one-quarter of the tax liability above this level. Again, as in the House bill, property with an estimated useful life of 8 years or more is fully taken into account in computing the credit, property with an estimated life from 6 to 8 years is taken into account at two-thirds of its basis, while property with an estimated life from 4 years up to 6 years is taken into account at one-third of its basis. In addition, as provided by the House bill, machinery and equipment are the principal types of investments eligible for the credit.

Despite the substantial similarity of your committee's and the House versions of the investment credit, there are important differences. The most important of these is the reduction of the amount on which depreciation may be taken, in the case of assets eligible for the investment credit, by the amount of the investment credit allowable. Your committee believes that where a taxpayer purchases a $100 asset, for example, if $7 of this purchase price is to be allowed as a direct reduction in his tax in the form of a credit, this same amount should not be allowed to him again as a depreciation deduction in computing income subject to tax. In such a case the taxpayer's real contribution toward the purchase of the $100 property is limited to $93 and therefore it seemed appropriate to your committee to limit the depreciation recovery to this same $93.

A second change made by your committee provides that where property is lost or destroyed as a result of a casualty or is stolen and is insured, reinvestment of the insurance proceeds in replacement property is not to be eligible for an investment credit. This eliminates the allowance of a credit in such cases, where the taxpayer has not made a contribution of additional funds toward the acquisition of new property.

A third change made by your committee provides that the investment credit is to be available only with respect to property acquired or constructed after June 30, 1962, rather than on or after January 1, 1962. Your committee concluded that taxpayers had no basis for assuming that an investment credit would be provided by Congress during the first half of 1962 when, for most of this period, the provision had not yet been even considered by the Senate or your committee. The allowance of the investment credit for this period, therefore, would represent a windfall for the taxpayers involved.

A fourth change made provides that livestock (including race horses) are not to be eligible for the investment credit since they are not included in the category of property resulting in ordinary income (to the extent of depreciation deductions) at the time of sale.

A fifth change made in the investment credit by your committee was to provide a 3-year carryback of unused investment credits. As pointed out above, the investment credit, in the case of a taxpayer with a tax liability of more than $25,000, could offset only one-quarter of the tax liability in excess of $25,000. Under the House bill any "unused" investment credit remaining could only be carried forward and used in any of the 5 succeeding years, again subject to the applicable limitations for those years. Testimony before your committee pointed out that the absence of a carryback of an unused credit in such cases would tend to encourage investment in prosperous periods and discourage it in depressed periods, when tax liability was relatively low. To offset this effect, your committee's bill provides for a 3-year carryback of any unused investment credit (but not to a period before June 30, 1962).

In a sixth and final change, your committee has deleted the requirement that one electing to treat a lessee of property as a purchaser must be engaged in the business of leasing property. Under your committee's change, any lessor of property meeting the other requirements may make the election.

C. General explanation of provision

1. *The general pattern of the credit.*—The bill provides a credit (in code sec. 38), which may be offset directly against income tax liability. The credit generally is an amount equal to 7 percent of "qualified investment" which includes both purchases of new equipment, and also, to a limited extent, purchases of used equipment. In the case of property with an expected useful life of 4 up to 8 years, the investment taken into account in computing the 7 percent credit is graduated from one-third in the case of the 4-year assets up to 100 percent in the case of property with a useful life of 8 years or more. In the case of most public utilities, however, only what amounts to a 3-percent investment credit is allowed. Under your committee's amendments the depreciation base of the assets involved is reduced (except for purposes of computing the credit) by the amount of the investment credit involved.

The types of property, whether new or used, which are included in qualified investment are described as "section 38 property." This property includes most tangible personal property. It also includes certain real property, other than buildings (or structural components) if the property is used directly in manufacturing, production, transportation, etc.

Once the amount of the 7-percent credit against tax is determined, the amount which may be claimed in any one year is limited to the tax liability, or if this tax liability exceeds $25,000, the credit (to the extent it exceeds this amount) is limited to 25 percent of the tax liability. However, a 3-year carryback and a 5-year carryforward are provided for any of these credits which because of this limitation are unused. The bill also provides that where the property is disposed of (within 8 years) before the end of its life as estimated for the credit the credit is reduced to the amount which would have been allowed initially had the useful life of the asset been correctly estimated.

These provisions are described briefly below.

2. Qualified investment.—Investment which is eligible for the 7-percent investment credit is referred to in the bill as "qualified investment" (sec. 46(c)). Qualified investment includes both new property and a limited amount of used property. Property qualifies for the investment credit in the year it is placed in service by the taxpayer, even though under the depreciation convention used by the taxpayer, he may not be eligible to start depreciation on the property until the coming year.

The percentage of investment which the taxpayer may take into account as qualified investment varies to some degree with the expected useful life of the property in his business. No part of the investment in property with an expected useful life of less than 4 years is taken into account. Property with an expected useful life of 4 years and up to (but not including) 6 years is taken into account at one-third of the amount of the investment actually made; property with an expected useful life of 6 years and up to (but not including) 8 years is taken into account on the basis of two-thirds of the investment made; and property with a longer life is taken into account at the full amount of the investment.

Public utility property is taken into account as qualified investment at three-sevenths of the amount otherwise allowable. Thus, in the case of 4- or 5-year public utility property, one-seventh of the investment is taken into account; in the case of 6- or 7-year property, two-sevenths of the investment is taken into account; in the case of property with a life of 8 years or more, three-sevenths is taken into account. This means that in the case of public utility property with an expected useful life of 8 years or more, in effect a 3-percent credit is allowed. Public utility property for this purpose means property used predominantly in an electrical energy, water or sewage disposal business, a local gas distribution business, a telephone business, or a domestic telegraph business, but only if the rates involved in all of these cases are subject to regulation by a governmental agency or commission.

Your committee's amendments provide that "qualified investment" is to be reduced in the case of property which is a replacement for other property destroyed or damaged by fire, storm, shipwreck, or other casualty or stolen, where this latter property was insured (or compensation was otherwise received). In such cases the amount treated as qualified investment in the case of the property acquired as a replacement is reduced by the amount of the insurance (or other compensation) or by the amount of the basis of the replaced property if lesser. This prevents a taxpayer from obtaining an investment credit windfall from insurance proceeds where the taxpayer neither puts up new funds nor expands his business. (This provision applies only when it results in a larger cutback in qualified investment allowable than the recapture rule described subsequently.)

3. New and used property.—The new property taken into account as qualified investment (sec. 48(b)), under your committee's amendments must be purchased or otherwise acquired after June 30, 1962, and its first use commenced by the taxpayer after that date. Other new property eligible for the credit also includes property constructed, reconstructed, or erected by the taxpayer after that date. These are the same rules which applied with respect to the new forms of depreciation provided in 1954.

Used property (sec. 48(c)), eligible for the credit, also must be purchased after June 30, 1962, but, of course, is not property which is new in use with the taxpayer. To prevent abuse, however, there has been omitted from the term "used property," available for the credit that which (after acquisition by the taxpayer) is used by a person who used the property before such acquisition (and also that which is so used by a person who is related to a person who used the property before its present acquisition).

The cost of any used property which may be taken into account is limited to $50,000 a year. Where used property with varying useful lives is acquired the taxpayer may select the property to be taken into account for the investment credit. Presumably he will select assets with lives of 8 years or more since there is no one-third or two-thirds reduction in such cases.

In the case of a husband and wife filing separate returns, the amount of used property which may be taken into account by each is $25,000 instead of $50,000, unless one of the two has not purchased any used section 38 property, in which case the other spouse may claim the entire amount up to $50,000. This prevents any double allowance for married couples. In the case of affiliated groups of corporations (with a 50-percent test of common ownership instead of the 80 percent usually applied), there is to be one $50,000 used property allowance for the group and it is to be apportioned among the members of the group in accordance with their purchases of this property. In the case of partnerships, this limitation applies both at the partnership level and also with respect to each partner. Thus, $50,000 is the limit with respect to used property which may be qualified for any partnership, and then there is a further $50,000 limit at the partner level. This latter limit may further restrict the used property eligible for the credit where a partner, in addition to his share of investment in one partnership, has, either from another partnership or as a sole proprietor, additional used property investment for which he may receive a credit. The total of these which qualify for the credit may not exceed $50,000.

To prevent a double allowance where used property is traded in on used property, or where used property is disposed of (otherwise than by casualty or theft) and other used property "similar or related in service or use" is acquired as a replacement, the cost otherwise allowable for the used property acquired is reduced by the adjusted basis of the property disposed of in both of these types of cases. However, this "replacement" reduction in the credit is not to apply where there otherwise is a reduction in the credit for the property disposed of because of its disposal within 8 years and before the end of what had been its estimated useful life. (See heading 6 below.)

4. "Section 38" property.—Section 38 property (defined in sec. 48(a)), is the only property (either new or used) which is treated as "qualified investment." Except for the exclusions noted below, all tangible personal property qualifies as section 38 property. Except for buildings and their structural components, real property which is used as an integral part of manufacturing, production or extraction or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services also qualifies as section 38 property. This is also true of real property (other than buildings and structural components) used for research or storage facilities with respect to any of the above categories. Tangible personal property is not intended to be defined narrowly here, nor to necessarily follow the rules of State law. It is intended that assets accessory to a business such as grocery store counters, printing presses, individual air-conditioning units, etc., even though fixtures under local law, are to qualify for the credit. Similarly, assets of a mechanical nature, even though located outside a building, such as gasoline pumps, are to qualify for the credit. Real property (other than buildings and structural components) which qualifies as integral parts of categories referred to above includes such assets as blast furnaces, oil and gas pipelines, railroad track and signals, and fences used in connection with raising cattle.

Section 38 property must be depreciable property and have a useful life of 4 years or more. As indicated elsewhere property with estimated useful lives of from 4 to 8 years is only partially taken into account for purposes of the investment credit.

There also are certain categories of property which are excluded from the definition of section 38 property and, therefore, cannot qualify for the credit. These exclusions are:

(1) Property used predominantly to furnish lodging or in connection with the furnishing of lodging. However, there are two exceptions to this exclusion. First, property used in nonlodging commercial facilities (such as a restaurant) located in lodging facilities (such as a hotel) may qualify for the credit if the nonlodging commercial facilities are available for use by the general public on the same basis as for the lodgers. Second, property used in a hotel or motel which primarily serves transient guests may qualify for the credit. The first of these two rules is essential to place nonlodging commercial facilities located in an apartment building, etc., on an equal competitive basis with similar facilities located elsewhere. Property necessary for the operation of a hotel or motel also is used in a regular commercial venture and, therefore, it was believed that it too should be eligible for the investment credit.

(2) Property used by a tax-exempt organization (other than in a business to which the unrelated business income tax applies). The limitation on the allowance of the credit in this case is designed to prevent an investment for use in connection with an exempt function from decreasing any tax on an unrelated trade or business.

(3) Property used by (or leased to or by) governmental units. Property leased to governmental units is omitted since allowing the lessor in such cases an investment credit would not be expected to increase the use of such property by the governmental units.

(4) Property used predominantly outside of the United States. However, there are certain exceptions where this type of property is eligible for the credit, namely, in the case of domestically owned aircraft, rolling stock of railroads, vessels and motor vehicles, where the use is partially within and partially without the United States. Similarly, an exception is made for domestically owned containers which are used in the transportation of property to or from the United States. A further exception is made for domestically owned property used in exploring for, developing, removing, or transporting natural resources from the outer Continental Shelf of the United States. Property used predominantly outside of the United States (with the exceptions noted) is omitted, since the primary purpose of the credit is to encourage investment within the United States.

(5) Livestock (including racehorses).

5. *Limitation on tax credit.*—The tax credit, under the bill, as amended by your committee (sec. 46(a)(2)) may not exceed the tax liability, or if the tax liability is in excess of $25,000, may not exceed $25,000 plus 25 percent of the tax liability over this amount. This limitation, while leaving substantial leeway for utilizing the credit, is designed to prevent it (in combination with other tax benefits) from relieving the taxpayer from any substantial tax contribution. However, in recognition of the problems of small business, the bill does not impose this limitation with respect to the first $25,000 of any tax liability.

Although this limitation with respect to the allowance of the investment credit is imposed for the year in which the investment is made, nevertheless, any investment credit which, because of this limitation, cannot be used in the current year may be carried to other years by the taxpayer. Under your committee's amendments the taxpayer may first carry an unused credit back to the 3 prior years (but not before June 30, 1962) and then forward to any of the succeeding 5 years using the credit in any of these years to the extent it is less than the applicable tax limitation.

Tax liability for purposes of this limitation is computed without regard to the accumulated earnings tax or personal holding company tax liability, but after the application of the foreign tax credit, the 4-percent dividends-received credit, the credit for partially tax-exempt interest and the retirement income credit. In order to prevent a full allowance with respect to $50,000 of tax liability (instead of $25,000) in the case of a married couple, the bill provides that for a married individual filing a separate return the tax liability limitation is $12,500 instead of $25,000. However, if either the husband or the wife has no qualified investment (or unused credit carryback or carryover), the one having the investment or carryover may make use of the entire $25,000. In the case of an affiliated group there is one $25,000 of tax liability which can be fully offset by an investment credit and this is by regulations to be apportioned among the members of the affiliated group.

6. *Recapture rule.*—To guard against a quick turnover of assets by those seeking multiple credit—the bill provides (in sec. 47) a special adjustment or recapture. Under this provision if property is disposed of, or otherwise ceases to be section 38 property, the tax for the current year is to be increased by the reductions in investment credits (which would have resulted in the prior years) had the investment credits allowable been determined on the basis of the *actual* useful life of the property rather than its *estimated* useful life. This means, for example, that if an asset which had previously been estimated to have a useful life in the business of 8 years or more actually is used by the taxpayer only for 6 years, the investment credit for the year in which the investment was originally made will be recomputed on the basis of two-thirds the investment made. Had this asset been sold after 4 or 5 years' use, the allowable investment would have been recomputed on the basis of one-third of the actual investment and had it been sold after a still shorter period, the credit would have been eliminated.

Although the credit is recomputed for the earlier year in which the investment was made, the actual adjustment in tax occurs in the current year, namely, the year in which the asset is disposed of (or otherwise ceases to be sec. 38 property). This makes it unnecessary actually to recompute taxes in the prior years, or to extend the statutory periods of limitations. An adjustment is also made in any carrybacks and carryovers of unused credits so that they too will reflect the reduced amount of investment to be taken into account.

Although disposal of assets (where this is less than 8 years) within a shorter period of time than their estimated useful life usually will be the factor resulting in downward adjustments in the credit allowed, the credit must also be adjusted if property ceases to qualify as section 38 property; where, for example, it is converted to use predominantly outside of the United States. A downward adjustment in the credit also is required where property is converted to public utility property for which only a reduced credit is available. As indicated previously, a credit is allowed for certain types of public utility property equal only to three-sevenths of the credit generally allowable. Where property is converted to such use (again, before the end of its estimated useful life and within the 8-year period) a downward adjustment must be made. In this case, however, instead of disqualifying one-third, two-thirds, or all of the property, depending upon the period of time involved before the conversion to public utility use is made, four-sevenths of such an adjustment is made, since the public utility property itself qualifies for the credit for the remaining period of time but on a reduced basis.

Few exceptions are made to the adjustment rule described above because in no case does this result in a lesser credit than would be available had the useful life of the property been estimated accurately. Moreover, since the tax increase occurs in the current year, and not with respect to the prior year in which the investment occurred, no interest is charged with respect to the increase in tax resulting from the reduction in credit. As a result, your committee believed that it was necessary to forego the application of the adjustment rule only in the case of the transfer of property by reason of the death of the taxpayer or in the case of corporations where a successor corporation "stands in the shoes" of the predecessor corporation. The successor corporation in such a case, of course, must continue to hold the property for the appropriate period of time, or an increase will be made in its tax because of the disposition of the property prior to the end of its estimated useful life. In addition, the recapture rule is not to apply where the replacement rule, applicable where insurance proceeds are received for casualty losses or thefts, results in a revenue reduction in qualified investment. (See No. 2 above.)

7. *Downward adjustment in basis of property.*—The bill as amended by your committee provides (sec. 48 (g)) that the cost or other basis of "section 38 property" is to be reduced by 7 percent of the qualified investment except for purposes of computing the credit itself. As previously indicated, this downward adjustment is provided because your committee believes that there is no reason to allow the taxpayer depreciation with respect to the portion of the investment in effect paid for by the Government.

The bill provides that the basis of all qualified investments is to be reduced by 7 percent. Since "qualified investment" is after adjustment for different estimated lives (and also after the special adjustment where the property involved is public utility property) the uniform 7-percent downward adjustment provides the appropriate result in most cases. However, there are cases where this adjustment may be too large. This is true, for example, where because of the limitation to 25 percent of tax liability, not all of the credit is used in the taxable year, 3 years to which the credit may be carried back and 5 years to which it may be carried forward. To compensate for this overadjustment the bill provides taxpayers with a special deduction in computing taxable income in the first year after all carryforwords for a credit have expired, equal in amount to any unused portion of the credit. If the taxpayer dies or ceases to exist prior to that time this special deduction (or appropriate portion of it) is allowed the taxpayer in his last year.

A second circumstance under which the downward adjustment referred to here may be too great is that where a property is disposed of before its full estimated life has expired and in less than 8 years. In such cases the investment credit is cut back under the recapture rule explained in the prior section with the result that the original adjustment to the basis of the property was too large. To the extent of this cutback in the investment credit, the bill provides for an increase in the basis of the property at the time just preceding its disposition.

8. *Election for leased property.*—The bill provides (in sec. 48(d)) that a lessor may elect with respect to new property to treat the investment as if made by the lessee instead of the lessor. This election applies only with respect to new property and is not available for used property. Permitting the investment credit to be passed on to the lessee in these cases is believed to be desirable since, as a result of this provision, it is possible for the lessor to pass the benefit of the investment credit on to the party actually generating the demand for the investment.

If the lessor makes this election, then the lessee is treated for purposes of this provision as if he had acquired the property himself, that is, generally he will be treated as if he had acquired the property for the lessor's cost or other basis for the property. However, if the lessor constructed the property (or a corporation controlled by or which controlled the lessor did so) the lessee is treated as having acquired the property for its fair market value. The useful life of the property in the hands of the lessee in such cases is to be its useful life in the hands of the lessor for purposes of computing the size of the credit available. This is true whether or not the lease itself is for a shorter period of time. Of course, in such cases if the lessee does not renew the lease and hold the property for the estimated useful life of the property in the hands of the lessor, then a downward adjustment will be made in his investment credit.

Where the lessee is allowed the investment credit there is no adjustment of the lessor's basis for depreciation (as discussed in No. 7 above) but a reduction of the lessee's deduction for rent is provided.

9. Special classes of taxpayers.—A number of special categories of taxpayers receive special tax treatment under the Internal Revenue Code which makes it inappropriate in their cases to allow the full investment credit. For other taxpayers, the code provides that income may be taxed in part to the organization and in part to its shareholders or beneficiaries. In these situations your committee's bill either cuts down the allowance of the tax credit in proportion to the special benefit received, or provides for the apportioning of the investment credit between the organization and its shareholders or beneficiaries in accordance with their sharing of income for tax purposes. Similar adjustments are also provided in the $25,000 tax liability limitation.

In the case of mutual savings banks, building and loan associations and cooperative banks, the investment credit allowable is reduced by 50 percent (largely offsetting the 60 or 50 percent special deductions they are allowed). The $25,000 tax liability limitation is also similarly reduced for these organizations.

In the case of regulated investment companies and real estate investment trusts, the qualified investment allowed them and the applicable $25,000 tax liability limitation are reduced in the same proportion in which their taxable income is reduced by dividends paid to shareholders or beneficiaries. Similarly, in the case of cooperatives, the qualified investment and $25,000 tax liability limitation to be taken into account are reduced in the same proportion in which their taxable income is reduced for patronage dividends (and in the case of exempt cooperatives its deductions for dividend payments on capital stock, patronage distributions with respect to U.S. business and income distributed to patrons from sources other than patronage).

In the case of subchapter S corporations, i.e., corporations treated in a manner similar to that of partnerships, since it is the shareholders, rather than the corporation, who are taxed on the income of the corporation, the bill (sec. 48(e)) divides the qualified investment for each year on a pro rata basis among the shareholders of the corporation at the end of the year. In this case since the shareholders are treated as the taxpayer, the investment maintains its character as new or used section 38 property in their hands. Similarly, the bill (in sec. 48(f)) provides that qualified investment in the case of estates or trusts is to be apportioned between the estate or trust on one hand and the beneficiaries on the other on the basis of the income of the estate or trust allocable to each. As in the case of the subchapter S corporations, the beneficiary is treated as the taxpayer with respect to the investment apportioned to him and therefore the investment retains its character in his hands as new or used section 38 property. The $25,000 tax liability limitation in the case of the estate or trust is reduced in proportion to the total income allocated to other than the estate or trust.

10. Carryovers in the case of certain corporate acquisitions.—Generally, in the case of certain tax-free acquisitions of assets of one corporation by another, present law provides that certain items of the first corporation are to be carried over and attributed to the second. This includes such items as net operating loss carryovers, earnings and profits, methods of accounting, methods of computing depreciation allowance, etc. The bill adds to this list (sec. 381(c)(23)) a carryover to the acquiring corporation in the case of these tax-free reorganizations of the status of the prior corporation with respect to items required to be taken into account for purposes of the investment credit. This mainly is concerned with (1) the carryover of the possibility of adjustment with respect to the investment credit where an asset is held for less than the full period of its estimated useful life and (2) the carryover of any unused investment credit in the prior 5 years.

11. Effective date.—The bill provides that the investment credit is to apply to taxable years ending after June 30, 1962. However, in the definition of new section 38 property and also used section 38 property (the only types of property eligible for the credit) it is provided that a credit is to be available only with respect to acquisitions after June 30, 1962, or in the case of property newly constructed, reconstructed or erected by the taxpayer, only with respect to the portion of the property which is constructed, reconstructed or erected after that date. The combination of the effective date and these definitions of new and used section 38 property in effect provide that the investment credit is to be available only with respect to property acquired (also property constructed, reconstructed, or erected by the taxpayer) after June 30, 1962, with respect to taxable years ending after that date.

III. APPEARANCES, ETC., WITH RESPECT TO LEGISLATION

(Sec. 3 of the bill and sec. 162(e) of the code)

A. Reasons for provision

Present law allows deductions for income tax purposes for ordinary and necessary expenses paid or incurred in carrying on a trade or business. No mention, however, is made in the statute of expenses incurred in making appearances, submitting material, or communicating with respect to legislative matters. However, Treasury regulations in effect prior to the enactment of the 1954 Code disallowed deductions for expenditures for such purposes (regulations 118, secs. 39.23(o)-1(f) and 39.23(q)-1(a)).

In 1959, the Supreme Court handed down two companion decisions upholding the validity of these regulations, *Cammarano* v. *U.S.* and *F. Straus & Sons, Inc.* v. *U.S.* (358 U.S. 498 (1959)). The Court held that although the amounts expended for legislative matters were "ordinary and necessary"—in fact essential to the very survival of the taxpayer's business—nevertheless they were not deductible because the regulations barred the deduction of this particular type of expense.

The Court recognized that the statute contained no provisions specifically supporting the regulations, but stated that they had acquired the force of law by reason of congressional reenactment of the underlying statute.

Following the *Cammarano* decision, the Treasury Department promulgated new regulations relating to deductions incurred with respect to legislative matters. These regulations, while following the general rules set forth in the earlier regulations, for the first time stated specifically that several different classes of expenditures are to be disallowed as deductions. For example, the new regulations require the disallowance of a deduction for the portion of dues and other payments to any organization, a "substantial part" of the activities of which consist of lobbying to the extent that such amounts are "attributable to" these activities. Similarly, the regulations now state that expenditures for the promotion or defeat of legislation include expenditures for the purpose of attempting to influence members of a legislative body, directly or indirectly, by urging or encouraging the public to contact the members.

The regulations issued by the Treasury Department in 1959 brought to a head many administrative and enforcement problems and uncertainties which have plagued both the Government and taxpayers. The difficulty in allowing trade or business expenses generally, but isolating expenses relating to legislative matters and denying deductions for them, stems in part from the difficulty in segregating and classifying such expenses. This is a form of detailed recordkeeping to which taxpayers are not accustomed. Moreover, in the case of many expenses which may primarily be incurred to inform the business itself as to the application of certain proposed legislation, when such information is also made available to legislators it is difficult to determine how an allocation of the expense should be made between legislation and mere planning of the company. Moreover, in the case of an organization, a determination must also be made as to whether the expenses of this type are substantial—a term which involves a difficult line of demarkation.

More important than the administrative and enforcement problems, however, are the policy considerations involved in denying expenses with respect to legislative matters. It appears anomalous, for example, that expenses incurred in appearing before legislative bodies or before legislators are not deductible while appearances before executive or administrative officials with respect to administrative matters, or before the courts with respect to judicial matters, are deductible where the expenses otherwise qualify as trade or business expenses. Your committee believes that the present bar on deductions with respect to legislative matters must be modified to place presentations to the legislative branch of Government on substantially the same footing in this respect as that which obtains in the other two coordinate branches of Government.

It also is desirable that taxpayers who have information bearing on the impact of present laws, or proposed legislation, on their trades or businesses not be discouraged in making this information available to the Members of Congress or legislators at other levels of Government. The presentation of such information to the legislators is necessary to a proper evaluation on their part of the impact of present or proposed legislation. The deduction of such expenditures on the part of business also is necessary to arrive at a true reflection of their real income for tax purposes. In many cases making sure that legislators are aware of the effect of proposed legislation may be essential to the very existence of a business. The deduction of legislative expenses for those who incur them for personal reasons is not proposed here, since personal expenses generally are not deductible with respect to administrative or judicial presentations and have no bearing on the determination of true taxable income of a business.

B. Comparison of committee amendment with House provision

Your committee has retained the House provision relating to appearances, etc., with respect to legislation. The only change made is the addition of one category of deductible expenses. Your committee's amendment provides, in addition to the categories specified in the House bill, for the deduction of expenses incurred by a taxpayer in carrying on a trade or business if the expenses are in direct connection with the communication of information between the taxpayer and employees or stockholders with respect to legislation, or proposed legislation, of direct interest to the taxpayer. As in the case of the categories referred to in the House bill, expenses of this type, in order to be deductible, may not be for participation or intervention in political campaigns on behalf of candidates for public office or in connection with attempts to influence the general public (or segments thereof) with respect to legislative matters, etc.

C. General explanation of provision

The bill adds a new subsection (sec. 162(e)) to the provision of present law relating to the deduction of trade or business expenses. It provides that certain types of expenses incurred with respect to legislative matters are to be deductible if in all other respects they qualify as trade or business expenses.

The expenses which may be deducted are divided into three categories. The first category relates to expenses in direct connection with appearances, submission of statements or sending of communications. These appearances, statements or communications may be presented either to committees or individual Members of Congress or to committees or individual members of State or local governmental legislatures. The second category of expenses which may be deducted are those in direct connection with the communication of information between the taxpayer and an organization of which he is a member. The third category of expenses which may be deducted are those in direct connection with the communication of information between the taxpayer and an employee or stockholder. This communication of information may be either from the organization, employee or stockholder to the taxpayer or vice versa. In the case of all three categories of expenses referred to above, in order for the expense item to be deductible, it must be concerned with legislation or proposed legislation of direct interest to the taxpayer (and to the organization in the second case). Thus, the expenses may not be in connection with legislative matters such as nominations, etc., but rather must be in connection with specific legislation or proposals for legislation.

The bill also provides that where a taxpayer is a member of an organization and the organization pays or incurs the expenses of the types referred to above on behalf of its members, the dues which the taxpayer pays to the organization in carrying on his trade or business are to be deductible to the extent they are used for such purposes. The remainder of the dues is likely already to be deductible as an ordinary and necessary business expense. Of course, the dues to an organization may be deductible although not all of the organization's legislative activity is connected with each specific member's trade or business. It is sufficient if all of the organization's legislative activity is related to the trade or business of a significant number of the members.

The bill provides two limitations on the deductions of the above-specified expenses for the specified types of legislative activity. It is not intended by your committee that any deduction be allowed for an amount paid or incurred for participation or intervention in any political campaign for any candidate. Of course, this includes participation or intervention in political campaigns in opposition to a candidate as well.

Your committee's bill further provides that no expense deduction is to be allowed for expenditures to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums. Thus, except to the extent allowed by existing law, no deduction is intended to be allowed for expenses incurred in connection with what is usually called "grassroot" campaigns intended to develop a point of view among the public generally which in turn is directed toward the legislators. However, your committee does not intend that this limitation should have any effect upon the deductibility of dues, contributions or other payments to organizations whose activities consist primarily of gathering and disseminating factual information, data and statistics. For example, a nonprofit organization would not be affected by the limitation if it were organized and operated for the propose of studying governmental affairs, Federal, State, or local (which might include analysis of legislation or proposed legislation) and of publishing and distributing to its members and the public factual reports and information on such governmental affairs. Such factual reports might contain data which could be used by subscribers and others to promote or defeat legislation, but so long as the organization itself did not engage in lobbying activities to promote or defeat legislation, payments to such organization will continue to be deductible to the same extent as under existing law.

Nothing in this provision is intended to permit the deduction of entertainment expenses. Such amounts, if deductible at all, must meet the tests set forth in section 4 of the bill, explained below, without regard to this provision.

This provision is to be effective with respect to taxable years beginning after December 31, 1962.

IV. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

(Sec. 4 of the bill and sec. 274 of the code)

A. Reasons for provision

The Treasury brought to the attention of Congress that widespread abuses have developed through the use of the expense account. In his tax message to the Congress last year, the President stated his conviction that entertainment and related expenses, even though having a connection with the needs of business, confer substantial tax-free personal benefits on the recipients, and that in many instances deductions are obtained by disguising personal expenses as business expenses. He recommended that the cost of such business entertainment and the maintenance of entertainment facilities be disallowed in full as a tax deduction and that restrictions be imposed on the deductibility of business gifts and travel expenses.

Much of the abuse described by the President can be traced to the broad judicial and administrative interpretation given to the term "ordinary and necessary" which has resulted in many entertainment expenses being allowed as deductions where their connection with a trade or business is quite remote. Under present law, where a business purpose, however slight, exists, then the entertainment expenses generally are fully deductible if they are "ordinary and necessary" business expenses.

After careful consideration of the proposal, your committee has concluded that deductions for entertainment and traveling expenses and business gifts should be restricted to prevent abuses. The committee agrees that this abuse of the tax law should not be condoned, but on the other hand it does not believe that complete disallowance as recommended by the President is the proper solution to the problem. Rather, your committee is convinced that expenses incurred for valid business purposes should not be discouraged since such expenses serve to increase business income, which in turn produces additional tax revenues for the Treasury. If valid business expenses were to be disallowed as a deduction (particularly expenses associated with selling functions), there might be a substantial loss of revenue where business transactions are discouraged, or where they fail to be consummated. Moreover, the entertainment industry employs large numbers of service personnel, most of whom are unskilled workers who would find it difficult to obtain new employment in other fields if the disallowance of entertainment expenses created considerable unemployment in the entertainment industry. In such cases, taxes now paid by these workers would be lost to the Treasury.

B. Comparison of committee amendment with House provision

The House bill provides rules which in general would: (1) disallow a deduction with respect to entertainment activities, except to the extent that the expense is directly related to the active conduct of a trade or business; (2) disallow a deduction with respect to entertainment facilities, unless the facility is used primarily for the furtherance of the taxpayer's trade or business and the expense is directly related to the active conduct of the trade or business; (3) abolish the Cohan rule by requiring the taxpayer to substantiate, by adequate records or by sufficient evidence corroborating his own statement, all expenditures for entertainment and related facilities, and for travel and gifts; and (4) limit the deduction for gifts to $25 per year per recipient.

Your committee's bill to a considerable degree retains the basic structure of the House bill. However, the effect of the principal provision (the disallowing of a deduction for certain entertainment expenses) has been modified to permit the deduction of expenses for goodwill where a close association is established between the expense and the active conduct of a trade or business.

The report of the Committee on Ways and Means made it clear that the House bill was not designed to disallow completely deductions for entertainment, amusement or recreation expenses, but rather it was intended to eliminate abuses. Under the general rule, no deduction would be allowed for any such expenses except to the extent that such expenses are directly related to the active conduct of a trade or business. Despite the clear language of the House bill and the stated intent of the provision, considerable uncertainty and confusion as to the actual effect of the House draft has been created by the interpretation given this language in the House committee report. It in effect interprets the proposed statutory language to disallow a deduction for any expense for entertainment, amusement, or recreation unless the expense is described in one of a series of specific exceptions to the general rule. Where the expense is covered by an exception, the rules of existing law would continue to govern the deductibility of the expense.

To eliminate the harshness resulting from the House report, amendment of the language of the House bill is necessary. Despite amendment of the House bill your committee has made certain that entertainment expense abuses are eliminated. By your committee's amendment an alternative rule is added to the House bill under which expenses for entertainment, amusement, or recreation (with respect to both activities and facilities) also will be deductible to the extent that such expenses are associated with the active conduct of a trade or business. This new language will permit deduction of expenses for entertainment, amusement, or recreation incurred for the creation or maintenance of business goodwill without regard to whether a particular exception applies. However, this new language will apply only if the taxpayer demonstrates a clear business purpose and shows a reasonable expectation of deriving some income or other benefit to his business as a result of the expenditure. If he meets this test, the expenditure will be considered to be associated with the active conduct of his trade or business; otherwise, the expense will be disallowed under your committee's amendment.

With respect to disallowance of a deduction for gifts in excess of $25, your committee has adopted the rule of the House bill but has modified the definition of "gift" for purposes of applying the limitation. Under the modified definition: (*a*) certain specialty advertising gifts, (*b*) advertising material for use in connection with the recipient's business, and (*c*) certain awards to employees costing not more than $100, will not be taken into account in determining whether the $25 limitation has been exceeded.

The requirements of the House bill regarding substantiation of claimed deductions for entertainment, amusement, or recreation expenses, gifts, and traveling expenses, have been approved without change.

The provision of the House bill which provided that expenses for meals and lodging included in the term "traveling expenses" were to be deductible only if "reasonable" has been clarified to assure that "traveling expenses" are not to include expenses for meals and lodging which are lavish or extravagant. In addition, your committee has added to the House-passed bill a new rule for the allocation of traveling expenses where the trip involves both business and pleasure. Under this rule, which would eliminate abuses involving tax deduction for vacation trips, if the trip is for more than 1 week and the personal portion of the travel time is in excess of 25 percent of the total time away from home, the traveling expenses (including meals and lodging) must be allocated between business and pleasure and only the portion allocated to business will be deductible.

As amended by your committee, the provisions of this section of the bill are to apply to taxable years ending after December 31, 1962, but only with respect to expenditures incurred after that date.

C. General explanation of provision

Your committee's bill adds a new provision to the code (sec. 274), which disallows, in whole, or in part, certain expenses which would be fully deductible under present law. The requirements imposed by this bill are in addition to the requirements for deductibility imposed by other provisions of existing law, which must be met by the taxpayer before this new provision becomes operative. Hence, if an expenditure is claimed as a business expense deduction under section 162, the taxpayer must first establish that it constitutes an ordinary and necessary expense incurred in carrying on a trade or business, before the new provisions of this bill become applicable.

Since the only purpose of this section is to disallow deductions, it will not make deductible any expense which is disallowed under the "ordinary and necessary" test of present law. Moreover, this section does not affect the question of the includibility or excludibility of an item in income of any individual. The rules presently applicable under present law will continue to govern in this respect.

1. *Disallowance of expenses for entertainment activities.*—The first part of the provision provides that no deduction is to be allowed for any expense with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, except to the extent that the taxpayer establishes that the expense was directly related to the active conduct of his trade or business, or that the expense was associated with the active conduct of his trade or business. Certain exceptions to this rule are provided, however, for expenses not required to meet the new tests. They are discussed in No. 6 below.

Entertaining guests at night clubs, country clubs, theaters, football games, and prizefights, and on hunting, fishing, vacation and similar trips are examples of activities that constitute "entertainment, amusement, and recreation." In addition, "entertainment" includes any business expense incurred in the furnishing of food and beverages, a hotel suite, a vacation cottage, or an automobile either to a customer (present or potential) or to any member of such a customer's family. If deduction is claimed for any expense for "entertainment, amusement, or recreation" the facts and circumstances of each particular case will determine the extent to which the expenses will be disallowed.

The trade or business of the taxpayer will determine whether an activity is of a type generally considered to constitute entertainment, amusement, or recreation. For example, with respect to a taxpayer who is a professional hunter, a hunting trip would not generally be considered a recreation-type activity. On the other hand, with respect to a taxpayer whose trade or business consists of selling machine tools or manufacturing clothing, a hunting trip generally would be considered a recreation-type activity. Similarly, attending a theatrical performance would generally be considered an entertainment-type activity, but in the case of a professional theater critic, attending a theatrical performance would not constitute an entertainment activity.

An objective standard also will overrule arguments such as the one which prevailed in *Sanitary Farms Dairy, Inc.* (25 TC 463 (1955)) that a particular item was incurred, not for entertainment, but for advertising purposes. That case involved a big-game safari to Africa. The taxpayer argued successfully before the Tax Court that the expense of the hunt (including costs of making motion pictures which were later shown to customers and potential customers) were incurred solely for advertising purposes. Under the bill, if the activity typically is considered to be entertainment, amusement, or recreation, it will be so treated under this provision regardless of whether the activity can also be described in some other category of deductible items. This will be so even where the expense relates to the taxpayer alone.

Many entertainment expenses which have a business connection nevertheless will not be deductible. To justify their deduction, a taxpayer must establish that the incurring of the expenses relating to the entertainment activities was directly related to or associated with his effort to obtain new business or to encourage the continuation of an existing business relationship. This means that he must show a greater degree of proximate relation between the expenditure and his trade or business than is required under present law. To illustrate this principle, assume a taxpayer entertains a buyer and the buyer's family at lunch and the theater. Under existing law, he claims a deduction for the entire expense; under your committee's bill no deduction would be allowed for any portion of the expense attributable to the buyer's family since as to them he is unable to show a sufficiently close relationship between the expense and his trade or business.

It will not be sufficient that the entertainment expense is vaguely or remotely connected with a business motive; it must be demonstrated that the predominant purpose of the expense is to further the trade or business of the taxpayer. Where goodwill generated by the expense is vague or where the possibility of the expenditure resulting in the production of income is remote, no deduction will be permitted. For instance, under present law a taxpayer may deduct expenses of entertaining buyers and others associated with his trade or business even though at the time he does the entertaining he already has more business than he can handle. Under your committee's amendment, however, no deduction will be allowed because, with a large backlog of unfilled orders, such entertainment ordinarily cannot be regarded as being associated with efforts to produce income.

Under the bill, although deduction for entertainment expenses is restricted, such expenses will not be disallowed merely because they are incurred for the purpose of generating business goodwill. Goodwill has long been recognized as a legitimate objective of business entertaining and where the purpose of the expense and its clear relationship to a business is firmly established, the expense ordinarily will continue to be deductible. However, nothing in your committee's bill is to be construed as allowing a deduction for any expense which is against public policy or which violates the public conscience. Deducting an expense incurred for such purpose under the guise of generating "business goodwill" will not be condoned and under your committee's amendment is not deductible. Thus, the cost of liquor purchased for the entertainment of customers and the promotion of goodwill (which under existing law has been held deductible) will be disallowed if the serving of liquor violates the public morals of the community as expressed in local law. Another example of expenses for immoral purposes which have been claimed on tax returns under existing law involves expenditures to provide "call girls" for the purpose of entertaining clients. Under your committee's amendment no deduction whatsoever is to be allowed for expenditures of this nature. In no legitimate sense are they "directly related to or associated with the active conduct" of a trade or business.

On the other hand, the following examples are indicative of circumstances under which entertainment expenses ordinarily will not be disallowed. Where the taxpayer conducts lengthy negotiations with a group of business associates and that evening the group goes to a night club, theater, or sporting event for relaxation, such entertainment expenses are regarded as directly related to the active conduct of business. Moreover, if a group of business associates with whom the taxpayer is conducting business meetings comes from out of town to the taxpayer's place of business to hold substantial business discussions, the entertainment of such business guests prior to the business discussions also is directly related to the conduct of the business. Similarly, if in between business meetings at a convention the taxpayer entertains his business associates attending such meetings, such expenses will be allowable.

Although your committee's bill permits entertainment expenses to continue to be deducted where a business purpose is shown, deduction will be limited to the portion of the expense which is directly related to or associated with business.

Objective standards will be employed to determine the apportionment between the part of the expense which meets either of these tests and the part which does not. Expenses not so related may not be deducted. Under this rule, if a taxpayer entertains a group of 10 individuals, 3 of whom are business prospects and 7 of whom are social guests, deduction will be allowed under the bill only for three-tenths of expenses incurred. Since the taxpayer's motive is not relevant to this determination, it would make no difference that the taxpayer in the above example would not have done the entertaining but for the attendance of the three business-related guests. This rule would disallow deductions for expenses in the following cases which, under existing law, are fully deductible:

A. 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.

B. Officer-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.

C. 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.

• In example A, no deduction would be allowed under your committee's bill because a vacation trip for a customer and his wife is not "directly related to the active conduct of the taxpayer's trade or business." In example B, deduction will be disallowed for expenses attributable to the taxpayer's wife and the customer's wife. In example C, no deduction would be allowed for expenses attributable to the taxpayer's wife.

> D. Customers and their wives are entertained by taxpayer at Derby parties such as breakfasts and luncheons, etc.; by furnishing box seats and tickets for the Kentucky Derby; and entertainment at the Derby.

Under existing law, the entire amount expended was claimed as a deduction and was allowed. Under your committee's amendment, no deduction is permitted for expenses attributable to customers' wives because their connection with the taxpayer's trade or business is remote.

No deduction will be allowable under this provision for any "entertainment, amusement, or recreation" expenses which under the circumstances in which they are incurred are lavish or extravagant. This will be so even where a direct business purpose is firmly established. The application of this rule can be demonstrated by the following example:

> E. The taxpayer, which is located in the midwest, asserted that lavish entertainment is essential in obtaining business and it established a Miami Beach residence for this purpose. The two principal officers and their wives are usually present at the residence when entertaining customers. Deductions allowed included depreciation on residence, food, liquor, boat expense and salaries of service employees and entertainment. Disallowance was made for amounts deemed to be personal expense.

Under the bill, no deduction would be allowed for any expenses attributable to the wives of either the principal officers or their customers (present or potential), or for any portion of the expenses incurred in example E which are lavish or extravagant. (The expenses of maintaining the residence are treated as expenses with respect to a facility, discussed in No. 2 below.)

Expenses for entertainment, amusement, and recreation should be identified by the taxpayer on his return and treated under the new rules of this bill. It will not be appropriate to include these expense items in other categories of business deductions, where their character will not be apparent, such as advertising, public relations, cost of goods sold, reimbursed expenses, etc. Failure to substantiate the claimed entertainment expenses by adequate records or other sufficient evidence may result in complete disallowance of the deduction.

2. Disallowance of expenses for entertainment facilities.—Your committee's bill (sec. 274(a)) also limits the deduction for expenditures incurred with respect to facilities used for entertaining. As in the case of expenses with respect to activities the new rules of this provision apply only if the expenses with respect to facilities qualify under existing law for deduction of business expenses. Moreover, these new rules establish additional tests which must be satisfied (in addition to the "ordinary and necessary" test of present law) in determining whether any deduction is to be allowed for expenses with respect to facilities. Under the bill, no deduction is to be allowed with respect to expenses relating to facilities unless the taxpayer establishes (1) that the facility was used primarily for the furtherance of his trade or business and (2) that the expenditure was directly related to the active conduct of his trade or business, or that it was associated with the active conduct of his trade or business. In no event can the deduction exceed the portion of the expense which is directly related to (or associated with) the active conduct of the taxpayer's trade or business. Certain exceptions to this rule are provided, however, for expenses not required to meet the new tests. They are discussed in No. 6 below.

The term "facility" includes any item of personal or real property owned or rented by the taxpayer, such as a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, automobile, airplane, apartment, hotel suite, home in vacation resort, dining room, and cafeteria. In addition to items commonly regarded as expenses "with respect to a facility," such as expenditures for the maintenance, preservation, or protection of the facility, this provision also relates to depreciation and losses realized on certain sales of entertainment facilities.

Under the bill, if a facility is used more than one-half for business entertaining, so that more than one-half of the entertainment expense with respect to such facility would be deductible as a business expense under present law, that portion would continue to be deductible to the extent it meets the test of being directly related to (or associated with) the active conduct of the taxpayer's trade or business. If less than one-half of such entertainment expense would be deductible under present law, no deduction would be allowed. For example, if the taxpayer acquires a fishing camp which he uses almost exclusively for entertaining business guests, deduction of the expenses of the camp will be disallowed only to the extent that it was used for personal or other nonbusiness purposes. On the other hand, if he uses it almost exclusively for personal purposes, but occasionally takes business guests to the camp, no deduction is to be allowed. A further illustration of this rule is as follows:

> A. The taxpayer corporation claims the purpose of maintaining a resort residence is to have a place available for business conferences. The resort residence has facilities for boating, fishing, and entertainment. It was established that the personal convenience, pleasure, and health of the chairman of the board of the taxpayer corporation was the principal reason for maintaining the residence. However, the evidence did indicate that there was some entertainment expense incurred for business purposes and a portion of the expense was therefore allowed.

Under the bill no deduction would be allowed in the foregoing example because the facts established that the primary use of the resort residence was not in furtherance of the taxpayer's trade or business.

Under this provision the facility must actually be used in furtherance of the taxpayer's trade or business; it is not sufficient that the facility is merely "available" for business use. And where the facility is one which is likely to serve the personal purposes of the taxpayer, it will be presumed that the facility was primarily used by the taxpayer for his personal purposes. To justify a deduction under such circumstances the taxpayer will have to clearly establish that the primary use of the facility was not for his personal purposes but was directly related to or associated with the active conduct of his trade or business. The following example illustrates the operation of this rule:

B. Closely held corporate taxpayer located in midwest maintains a summer home in Maine. Principal stockholder and wife spend 2½ months each summer at the Maine home and entertained high officials (and wives) of customers.

Under existing law the taxpayer in this case established that the summer home was used partly for business entertainment and was permitted to deduct a portion of the expenses attributable to the summer home. Under the bill, however, because the personal purposes of the principal stockholder are served by use of the corporation's summer home, it will be presumed that his personal purposes were primarily served by such use.

These rules will prevent tax abuses involving the use of luxury facilities for entertainment, amusement, or recreational purposes. Under these rules a taxpayer who lives in a luxurious apartment and who presently deducts a portion of its rent on the ground that the apartment is used for occasional entertaining of business guests (and thus has a business purpose), no longer will be able to deduct any portion of the rent because the principal purpose of the apartment is personal, rather than business. Moreover, a swimming pool constructed at the taxpayer's residence may not be charged off for tax purposes as an ordinary and necessary business expense because such a facility is presumed to be used primarily for personal, family or living purposes unless the taxpayer can establish by a preponderance of the evidence that it was used principally in connection with his trade or business.

As in the case of activities described above, no deduction will be permitted for lavish or extravagant expenses incurred with respect to facilities. This means that luxurious resort facilities maintained for the purpose of entertaining will no longer be fully deductible. This rule is illustrated as follows:

C. Taxpayer, a domestic manufacturing corporation, owns luxurious facilities on a subtropical island. The principal use of the property is for entertainment of executives and key personnel of customer firms. Fishing cruisers are maintained and air trancportation 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 the island.

Under existing law the entire amount expended for maintenance of the resort and the airplanes (other than adjustments for amounts considered personal expenses of officers and employees) is deductible. Under the bill no deduction would be allowed for any expense which under the circumstances is either lavish or extravagant. Moreover, no deduction will be allowed with respect to expenses attributable to a member of the customer's (present or potential) family but the family's use of the facility will be considered in determining whether the use of the facility is primarily for personal purposes. In addition, as indicated in the portion of this report describing the deductibility of expenses for entertainment activities, expenses for vacations for customers may not be deducted. Where the expenses with respect to the facility are for "vacations," they will be disallowed under your committee's bill.

Club dues and fees paid to any social, athletic or sporting club or organization are treated by the bill as an expense with respect to a facility used for entertainment and therefore will not be deductible where the primary use of the club facilities is personal. If membership entitles the member's entire family to use the facilities of the club, their use as well as his will be considered in determining whether business use of the club exceeds personal use. Where the primary use of the club facilities is in furtherance of a trade or business the cost of the club dues or fees will be deductible to the extent of the use directly related to (or associated with) the active conduct of business. Thus, if membership in a club costs $100 per year and the club is used for such clear business purposes three-fourths of the time, $75 will be deductible. As in the case of other facilities, it is the actual use of the club which establishes the deductibility of the club dues, not its availability for use, and not the taxpayer's principal purpose for joining the club. However, this does not mean that out-of-pocket business entertainment expenses incurred at a club will not be deductible where the required relationship between the entertainment and the taxpayer's trade or business is shown to exist. Such expenses will be deductible under the rules applicable to entertainment activities without regard to the tax treatment of club dues.

Club dues for this purpose do not include dues or fees paid for membership in such civic organizations as Kiwanis, Lions Club, Rotary, Civitan, and similar groups because these organizations are not social, athletic or sporting clubs. Similarly, professional associations such as bar associations and medical associations are not considered social, athletic or sporting clubs. Deductibility of these dues will not be affected by the new rules of this bill, but will continue to be governed by the rules of existing law.

3. *Business gifts.*—Under the bill, deduction for business gifts will be disallowed to the extent that the total gifts during the year exceed $25 with respect to any person. Where gifts are made to the wife of a man who has a business contact with the donor, these gifts are considered as made indirectly to the husband (for purposes of the limitation).

However, your committee has modified the definition of "gift" contained in the House provision so that items of a clear advertising nature which cost $4 or less will not be required to be taken into account in applying the $25 limitation. The purpose of this modification is to assure that businessmen who advertise their products or services by means of gifts of small value, commonly described as specialty advertising, may continue to do so without being burdened with the maintenance of detailed records of the amount of specialty advertising used with respect to each business prospect. This exception which includes such items as pens, desk sets, and plastic bags and cases, will apply only if the donor's name is clearly and permanently imprinted on the article.

Another modification of the definition of "gift" involves items such as signs, display racks, or other promotional material donated to a retailer by a producer or wholesaler for use on the business premises of the retailer. This material, generally referred to as point-of-purchase advertising, is not a gift; it is simply a form of advertising used right in the store to aid in the marketing process. As in the case of specialty advertising referred to in the preceding paragraph, this exception for point-of-purchase promotional devices used in normal business operations will eliminate the necessity of manufacturers or wholesalers (who donate the promotional material to retailers) maintaining detailed records and accumulating costs of promotional material with respect to each donee.

The third modification of the definition of "gift" excludes items of tangible personal property which have a cost to the taxpayer of $100 or less if the item is awarded to employees by reason of length of service or for safety achievement. It is a common practice of many employers to give such items as pins or watches to employees upon their completion of a specified number of years of satisfactory employment or in recognition of some safety achievement. Your committee felt that gifts for these purposes which serve to strengthen the relationship between business and its employees should not be discouraged by the tax law. This exception will permit the practice to continue under the rules of existing law.

There is the possibility of overlapping application of the entertainment expense and gift provisions in this new section. An item which might be held to be a gift might also be held to be an entertainment expense. For example, tickets to a theater might fall in either category. Since different rules will apply depending upon the category in which the expense item falls, specific regulatory authority is given to the Secretary of the Treasury or his delegate to prescribe, in cases where both provisions would otherwise apply, which provision is to govern. Thus, a "gift" of theater tickets probably would be classified as coming under the entertainment provision, while a book probably would be classified as coming under the gift provision.

4. Allocation of traveling expenses.—Your committee has added to the House bill a provision which will require taxpayers to allocate traveling expenses (including meals and lodging) between the portion of a trip which is for a business purpose and the portion which is for pleasure. This new rule will eliminate, in many cases, the "but for" rule of existing law under which a taxpayer is permitted to deduct his entire traveling expenses (even where a substantial portion of the time away from home is for purely personal purposes) if he is able to establish that the primary purpose of the trip was connected with a trade or business. This amendment will eliminate abuses whereby taxpayers often arrange vacations to coincide with a business trip so that they thereby, in effect, obtain a deduction for the vacation travel. However, to insure that this new rule will not impose unreasonable burdens on taxpayers to allocate trips between business and personal purposes where the duration of travel is only for a short period, your committee has provided that the allocation rule is not to apply where the period the taxpayer is away from home does not exceed 1 week, or where the time spent on the personal portion of the trip is less than 25 percent of the entire period the taxpayer is away from home on the trip. Where no allocation is required to be made, deduction of traveling expenses will continue to be governed by the primary purpose test of existing law.

5. Disallowance of expenditures not substantiated.—Under the bill, taxpayers will be required to substantiate their entertainment and related expenses, their traveling expenses and gift expenses. The bill provides that the taxpayer must substantiate by adequate records or by other sufficient evidence corroborating his own statement: the amount of such expense or other item; the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift; the business purpose of the expense; and the business relationship to the taxpayer of the person entertained, using the facility, or receiving the gift.

This provision is intended to overrule, with respect to such expenses the so-called *Cohan* rule. In the case of *Cohan* v. *Commissioner,* 39 F. 2d 540 (C.A. 2d, 1930), it was held that where the evidence indicated that a taxpayer had incurred deductible expenses but their exact amount could not be determined, the court must make "as close an approximation as it can" rather than disallow the deduction entirely. Under your committee's bill, the entertainment, etc., expenses in such a case would be disallowed entirely.

The requirement that the taxpayer's statements be corroborated will insure that no deduction is allowed solely on the basis of his own unsupported, self-serving testimony. However, the degree of corroboration required to support a claimed deduction will vary as respects the business relationship and purpose, the time and place, and the amount of the expense. Thus, oral testimony of the taxpayer together with circumstantial evidence available, may be considered "sufficient evidence" for the purpose of establishing the business purpose required under the new provision. However, oral testimony of the taxpayer plus more specific evidence would be required to be "sufficient evidence" as to the amount of an expense.

Generally, the substantiation requirements of the bill contemplate more detailed recordkeeping than is common today in business expense diaries. However, a clear, contemporaneously kept diary or account book containing information with respect to the date, amount, nature and business purpose of the expense may constitute an adequate record under this provision. Moreover, expenditures merely incidental to entertainment, travel, etc. (such as taxicab fares, tips, and similar payments) will be deductible if they are substantiated by such a diary, account book, or similar record.

The following example illustrates the operation of the requirements of this provision: Taxpayer establishes that he traveled from California to New York on business. He should retain receipts for his transportation and hotel expenses while in New York. However, expenses incidental to that trip such as taxicab fares, tips, business luncheons, etc. could be substantiated by entries in a diary.

Your committee does not intend by this substantiation requirement to deny a taxpayer deductions for entertainment, etc., expenses where he has no records if it can be shown that the failure to produce substantiating records was due to circumstances beyond his control, such as destruction of his records by fire or flood. In such a case, the taxpayer will be permitted to reconstruct the business entertainment, travel, or gift expenses incurred by him in the taxable year.

Under the bill, the Secretary or his delegate may, by regulation, prescribe certain situations in which the substantiation requirements will not be applied. For example, it may be provided that substantiation will not be required for traveling expenses, where such expenses (including the cost of meals and lodging) do not exceed prescribed minimum amounts. This will be of special benefit to employees whose per diem allowance while traveling is within limits established by the Secretary under this provision. Thus, if regulations are issued under which substantiation will not be required for traveling or entertainment expenses where per diem allowances do not exceed 125 percent of per diem allowed a Government employee in the same locality, it would be sufficient evidence for purposes of the substantiation rule to establish only the amount of the allowance and the fact that the business travel occurred.

6. *Exceptions where disallowance provisions will not apply.*—The bill contains nine exceptions to the general disallowance provision described above under heading 1 or 2. Where an expense falls within one of the enumerated exceptions, the item will continue to be deductible to the same extent as allowed by existing law. However, the new substantiation requirements (discussed under heading 5) will have to be satisfied with respect to any such expense. The exceptions are as follows:

(*a*) Expenses for food and beverages furnished under circumstances which are of a type generally considered to be conducive to a business discussion. The question as to whether the circumstances are conducive to a business discussion are to be tested by such standards as: First, the surroundings in which the meal or beverage was furnished; second, the taxpayer's trade or business or income-producing activity; and third, the relationship to such trade, business, or activity of the persons to whom the food and beverages were furnished. Under this exception, the general custom of entertaining business guests at meals in restaurants and hotels would not be disallowed if they meet the ordinary and necessary test of existing law. This should leave undisturbed the most significant portion of goodwill entertainment conducted in this country. However, under this exception, it will not be possible to deduct luncheon expenses of a so-called reciprocity luncheon group under which a group of businessmen frequently lunch together and alternate in paying the check (and claiming it as a business expense deduction). This practice is not connected with a trade or business but is a personal or social expenditure which is not deductible under existing law.

(*b*) Expenses for food and beverages (and facilities used in connection with them) furnished on the business premises of the taxpayer primarily for his employees. This is intended to exclude from the disallowance provision such facilities as a company cafeteria or an executives' dining room. This exception would continue to apply even though guests are occasionally served in the cafeteria or dining room.

(*c*) Goods, services and facilities to the extent that the entertainment, amusement, or recreation (or use of the facility) is treated on the taxpayer's return with respect to the recipient of the entertainment as compensation paid to an employee and from which income tax is withheld. For example, if the taxpayer permitted an employee to use a yacht for a vacation and treated the expenses for its use as compensation paid to the employee for purposes of the withholding tax and for purposes of the taxpayer's tax return, maintenance and crew costs attributable to such use would be deductible in full because of this exception. On the other hand, where a yacht was used exclusively for business entertaining the salaries paid to the captain and crew, even though they were treated as compensation and withheld on, would not come within this exception because they are not the recipients of the entertainment. Rather, the deductibility of the salaries would be determined under the general rule of the provision as an expense with respect to an entertainment-type facility.

(*d*) Expenses paid or incurred by the taxpayer where he pays or incurs the expenses for his employer or a client, customer, etc., and where he is reimbursed by the employer or client, etc. This is designed to prevent the double disallowance of a single expenditure, once to the employee or practitioner, etc., and a second time to the employer or client, etc. This provision will not apply, however, in the case of an employee where the employer treats the amount paid to him as compensation. It also will not apply in the case of a practitioner, etc., unless he accounts to the client, etc., for the expenses incurred. The accounting must represent sufficient substantiation to meet the tests set out under heading No. 5. Thus, if a lawyer enters into a fee arrangement under which his client agrees to reimburse him for expenses (including entertainment expenses) the exception will not apply unless he accounts to his client sufficiently to enable the client to substantiate the expenses as required by the bill.

(*e*) Expenses incurred for recreation, social, or similar activities (including facilities) primarily for the benefit of employees. The employees referred to in this case are those, other than officers, shareholders, or highly compensated employees. An individual would be considered a shareholder only if he (taking into account holdings of members of his family) holds an interest in the corporation of 10 percent or more. This category is intended to pertain to the usual employee fringe benefit programs, such as expenses of operating a company swimming pool or baseball diamond, as well as the expenses of the annual company picnic or Christmas office party.

(*f*) Expenses directly related to business meetings of the taxpayer's employees, stockholders, agents, or directors. While this category will apply to business meetings where some social activities are provided, it is not intended to apply to gatherings which are primarily for social purposes rather than for the transaction of the employer's or company's business.

(*g*) Expenses directly related and necessary to attendance at a business meeting of an organization, such as a trade association, chamber of commerce, real-estate board, etc., described in section 501(c)(6) of the code.

(*h*) Expenses for goods, services, and facilities made available to the general public by the taxpayer. This pertains to expenses for the entertainment of the general public by means of television, radio, newspapers, and the like. It also permits deductions for expenses for parks, etc., maintained by companies where the general public may attend. Expenses of distributing samples to the general public would also come within this exception.

(*i*) 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. This exception is designed to insure that a taxpayer who sells entertainment to others will be allowed to deduct expenses of producing that entertainment. Thus salaries paid to employees of nightclubs and amounts paid to performers other than employees will continue to be deductible by the operator. Moreover, since this type of expense is not considered to be "entertainment" the detailed substantiation requirements prescribed in this bill will not apply.

7. *Interest, taxes, casualty losses.*—The restrictions provided by the bill are not to apply with respect to items which are deductible under specific provisions of law which apply both to business and nonbusiness taxpayers. Thus, deduction for interest paid on a loan to acquire an entertainment facility or property taxes paid with respect to it would continue to be allowed as a deduction, whether or not the entertainment facilities meet the tests of the new provision.

8. *Treatment of entertainment-type facilities.*—Under the bill, if deductions with respect to entertainment-type facilities are disallowed, the disallowed portion is to be treated as an asset which is used for personal, living, and family purposes, rather than as an asset used in the trade or business. Under this provision the basis of such an entertainment-type facility will be adjusted for purposes of computing depreciation deductions and determining gain or loss on the sale of such facility in the same manner as other property (for example, a residence) which is regarded as used partly for business and partly for personal purposes. Thus, if a taxpayer has a yacht which is used three-fourths for direct business entertainment purposes, and he ordinarily would be entitled to $1,000 for depreciation with respect to the yacht (if it were used entirely for business), $250 of this amount would be disallowed as a depreciation deduction and would be included as a part of the basis of an asset not used in the taxpayer's business.

9. *Meals and lodging while in travel status.*—The bill, as amended by your committee makes clear that the deduction provided for traveling expenses by section 162(a)(2) of present law is not to include expenses for meals and lodging which are lavish or extravagant under the circumstances.

10. *Effective date.*—The amendments made by this provision are to apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after that date.

V. DISTRIBUTIONS IN KIND BY FOREIGN CORPORATIONS

(Sec. 5 of the bill and sec. 301 of the code)

A. *Reasons for provision*

Under present law, when a distribution in kind is made by a corporation to a shareholder which is also a corporation, the amount which is treated as a distribution is the fair market value of the property received or, if lower, the adjusted basis of the property in the hands of the distributing corporation. Where both the distributing corporation and its corporate shareholder are domestic corporations, taking into account the adjusted basis when it is lower than the fair market value of the property may be justified on the grounds that the appreciated property is still owned by a corporation and, in fact, very little has happened. Furthermore, if the distributee corporation sells the property, the same amount of gain will be realized and taxed as if the distributor corporation had sold it. Where the distributing corporation is a foreign corporation, however, the device of distributing to its U.S. corporate shareholder property which has appreciated in value can be used as a device to permit the U.S. corporation to realize on the earnings and profits of the foreign corporation at minimum U.S. tax. Assume, for example, that an American parent has a 100-percent owned foreign subsidiary. This foreign subsidiary has $100,000 in accumulated earnings and profits resulting from foreign earnings, all of which enjoyed complete deferral from U.S. tax. Assume further that the foreign subsidiary is in a position to distribute to its American parent either $50,000 in cash or a property having a fair market value of $50,000 but an adjusted basis of only $20,000. Under existing law, the dividend income to the American parent is $50,000 if the cash is distributed but is only $20,000 if the property is distributed. Under the amendment provided by this bill, however, the dividend income to the parent is the same amount ($50,000) whether the cash or the property is distributed. This result is believed appropriate since the increase in value of the parent's assets is the same whether it receives the cash or the property.

B. Comparison of committee amendment with House provision

Your committee has retained the House provision with one modification. It has deleted the subsection in the House bill which, only for purposes of computing the allowable foreign tax credit, treats as the amount of the distribution the adjusted basis of the property which is distributed (where this is less than its fair market value). Your committee believes that since the distribution itself is to be taken into account at its fair market value, it would only be appropriate for purposes of determining the foreign tax credit, allowable with respect to this same distribution, to treat this distribution as sharing in the creditable foreign taxes in proportion to the fair market value of the distribution, rather than in proportion to its adjusted basis as under the House bill. This will maintain the current practice with respect to the valuation of the distribution, for purposes of allowing a foreign tax credit, in the case of those distributions in kind which under existing law already are taxed to the corporate recipients only at their fair market value.

C. General explanation of provision

This provision amends existing law (sec. 301(b)(1)(C)) to provide that where there is a distribution in kind from a foreign corporation and the shareholder is a corporation, then the amount of the distribution for dividend purposes is to be the fair market value of the property distributed, and not its adjusted basis in the hands of the distributor where that is lower.

An exception to the rule described above is provided where the distributing corporation, although a foreign corporation, during the 3 years ending with the close of the corporation's taxable year derived more than 50 percent of its income from sources within the United States. In such cases, to the extent that the income is subject to U.S. tax, the corporation receiving the dividend can continue to apply the rule generally available for domestic corporations. Thus, to the extent the dividend is treated as eligible for the 85-percent dividends received deduction, the amount of distribution will be the adjusted basis of the property to the distributing corporation where this is lower than its fair market value.

Your committee's amendment differs from the House bill in that, in computing the foreign tax credit allowable with respect to the distribution in kind, the distribution is to share in the creditable foreign taxes on the basis of its fair market value rather than in proportion to its adjusted basis, where this is lower. This continues the rule in present law which is that the amount considered to be a dividend also is the amount taken into account for purposes of allowing a foreign tax credit.

The bill also makes appropriate basis adjustments to take into account the changed rules with respect to dividend distributions.

The amendments made by this provision are to apply to distributions made after December 31, 1962.

VI. MUTUAL SAVINGS BANKS, ETC.

(Sec. 6 of bill and secs. 593, 595, and 7701(a) of code)

A. Reasons for provision

Until 1952 mutual savings banks, domestic building and loan associations, and certain cooperative banks (hereinafter referred to as mutual savings institutions) were exempt from Federal income tax. This exemption had initially been based upon the premise that the members' money in the case of these institutions was being used for loans to members, or that the institutions were in effect doing business with themselves and that since the earnings of the institutions belonged to the depositors rather than to them, there could be no profit on which to impose an income tax.

In 1951, however, Congress repealed the exemption of these mutual savings institutions and subjected them to the regular corporate income tax. At the same time, however, these institutions were allowed a special deduction for additions to bad debt reserves which proved to be so large that they have remained virtually tax exempt since 1951. The 1951 legislation provided that deductions could be made for additions to a reserve for bad debts in whatever amount the institution deemed appropriate so long as (1) the amount set aside each year did not exceed the taxable income (before this deduction) of the institution for the year, or (2) its total reserves and surplus did not exceed 12 percent of its deposits or withdrawable accounts at the close of the year.

The President, in his tax message of April 20, 1961, observed that—

> Some of the most important types of private savings and lending institutions in the country are accorded tax deductible reserve provisions which substantially reduce or eliminate their Federal tax liability.

He further stated that—

> These provisions should be reviewed with the aim of insuring nondiscriminatory treatment.

The Secretary of the Treasury in his appearance before your committee stated:

> 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, 1952–61, 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.

Your committee has reviewed the tax treatment of the mutual savings institutions. It agrees with the House that the present bad debt reserve provisions are unduly generous and that they require revision.

B. Comparison of committee amendments with House provision

Your committee has retained the basic House provisions relating to deductible reserves for these mutual savings institutions but has reduced the reserve deduction for stock companies and has made a number of relatively minor modifications in the generally applicable reserve provisions which in large part are designed to restrict the reserves available. In addition, it has provided a new definition of domestic savings and loan associations, has removed certain excise tax exemptions presently available to these institutions, and made another amendment relating to the deduction of dividends paid to depositors.

The House bill amends the special bad debt provisions of existing law which are applicable to these mutual savings institutions to provide that they may add to these reserves for bad debts each year whichever of the following is the greatest:

(1) 60 percent of taxable income for the year computed before a bad-debt deduction,

(2) An amount sufficient to bring the balance of the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year, plus an amount sufficient to bring the balance of the reserve for losses on other loans to a reasonable amount, or

(3) If an institution demonstrates a need for a reserve greater than is permissible under (1) or (2), an amount sufficient to bring the overall balance of its reserves to a "reasonable" amount.

Your committee has amended the 60 percent of taxable income reserve addition referred to in No. (1), above, to provide that the the amounts added to the reserve under this provision may not increase the reserve for losses on qualified real property loans to more than 6 percent of these loans. This amount, which is double the 3 percent referred to in No. (2), above, in your committee's estimation should provide an adequate protection against losses. Therefore, the deduction of any amount in excess of this is believed inappropriate.

Your committee also has adopted an amendment to provide that the deduction allowable under any of the three alternatives referred to above is not to be allowed to the extent it would increase the reserve for losses on qualifying real property loans together with the reserve for losses on nonqualifying loans and surplus, undivided profits, and reserves attributable to years beginning both before and after December 31, 1951, to more than 12 percent of total deposits or withdrawable accounts. This 12-percent limitation is substantially the same as the restriction in existing law and has been added by your committee to give assurance that these mutual savings institutions will in no event receive deductions for building up reserves in excess of those allowable before the enactment of this bill.

The House bill provided that the reserve for losses on qualified real property loans at the end of 1962 was to be established out of existing reserves up to a level of 3 percent of the qualifying loans outstanding at that time. For this purpose only those reserves were to be taken into account which were attributable to years beginning after December 31, 1951, the year when these savings institutions first became taxable institutions. Your committee has concluded, however, that it is appropriate to take into account pre-1952 reserves to the extent necessary to obtain a 3-percent beginning reserve. In this regard it should be noted that Congress when it first made these institutions taxable in 1952 specified that the reserves then set up were to be made with "due regard" to the pre-1952 reserves. Your committee's amendments likewise provide that these reserves are to be taken into account for purposes of establishing the 3-percent reserve. However, recognizing that these amounts are attributable to periods before these institutions were taxable, your committee's amendments provide that these pre-1952 reserves are to be taken into account only in determining the balance in the reserve. Thus, if the institution believes that the reserves it needs are less than this 3 percent then, to the extent pre-1952 reserves were taken into account, these funds may be distributed to depositors or used for other purposes without tax effect. However, in applying the 3-percent limitation (in determining whether deductions are allowable) such amounts will be treated as if they were still in the reserve.

Your committee, recognizing the greater hazards of a new business, concluded that the 3-percent level of reserves, previously referred to, should appropriately be increased to 5 percent with respect to the first $4 million of loans (a maximum increase in the reserves of $80,000) during the first 10 years of mutual savings institutions' existence. This amount is not to be available to stock savings and loan associations.

Your committee has also considered the fact that stock savings and loan institutions, although having many of the same characteristics as the mutual savings and loan associations are, nevertheless, commercial enterprises more nearly comparable to banking institutions than are the mutual associations generally. For that reason, although these associations are generally allowed the same treatment as the mutual savings institutions, your committee concluded that it was appropriate to provide a somewhat lower maximum addition to reserves in the case of the stock companies. For that reason, it is provided that 50 percent of taxable income instead of 60 percent is the maximum addition to reserves that such companies may make under alternative No. (1) referred to above.

Your committee also has provided a new definition of domestic building and loan associations. The definition appearing in the House bill in general provided that substantially all of the business of the institution must consist of accepting savings and investing the proceeds in loans secured by residential real property and other loans to the extent authorized to be made by a Federal savings and loan association under the Home Owners Loan Act. Your committee was concerned with the application of this definition because of the uncertainty as to what might be considered investing substantially all of the proceeds in residential real property. It also doubted the desirability of permitting the tax status of these institutions to turn, in part at least, upon the types of investments allowed them under the Home Owners Loan Act, which has different standards for determining allowable investment. In view of these considerations your committee has provided a more specific definition which, nevertheless, continues to require these institutions to devote most of their proceeds to home loans.

The definition provided by your committee in general provides that 90 percent of the total assets of the institution must be invested in loans secured by an interest in real property (or for certain other closely associated uses). It further provided that of this 90 percent of total assets, at least 80 percent (72 percent of total assets) must be invested in residential real property. Furthermore, 70 percent of this 90 percent (63 percent of total assets) must be invested in residential real property containing four or fewer family units. It is recognized that an institution may under special circumstances not be able to obtain loans on real property, residential real property or 1- to 4-family unit residential real property. Therefore, the new definition provides that cash and Government obligations to a limited extent may also qualify under any of the percentage requirements specified above. It is not intended, however, that cash or Government obligations be used as a means of expanding nonresidential loans beyond the difference between the 72 percent of total assets and the 90 percent of total assets (except to the extent cash and Government bonds are less than 10 percent of total assets) nor is it intended to permit the expansion of other than 1- to 4-unit residential loans beyond the difference between the 63 percent of total assets and the 90 percent of total assets (again except to the extent that the cash and Government obligations are less than 10 percent of total assets). Therefore, although the cash and Government obligations may be taken into account in determining qualification under the 72 percent or 63 percent limitations, this cannot be done in a manner which permits the expansion of the otherwise nonallowable loans above the difference between the 72 percent and 90 percent (namely, 18 percent of total assets for other than residential loans and cash and government obligations) or the difference between the 63 percent and 90 percent (namely, 27 percent of total assets for other than for 1- to 4-family residential unit loans and cash and Government obligations), except to the extent that the cash and Government obligations are less than 10 percent. Also included are tract loans where the proceeds of the loan will be used for any of the categories specified, interests in such loans and improvements loans which are concerned with such property. In addition, your committee has provided that generally none of the assets of one of these savings institutions may be invested in the stock of any corporation other than that of an instrumentality of the United States or of a State or its political subdivision.

The House bill repealed exemptions granted Federal savings and loan associations from excise taxes on communications, and on transportation of persons. Your committee is in accord with the repeal of these exemptions but in addition has provided for the repeal of exemptions from documentary stamp taxes provided for these savings institutions. However, it is made clear that the documentary stamp tax on the insurance or transfer of shares of stock is not to apply in the case of shares or certificates representing deposits or withdrawable accounts, which are comparable to bank accounts where no documentary stamp tax is applicable.

The final amendment made by your committee provides that dividends and interest paid by savings institutions which are chartered and supervised as savings and loan or similar associations under Federal or State law are to be deductible to the institution in computing its income subject to tax in the same way as interest on deposits is deductible to commercial banks. This is to be true whether or not the savings institution meets the definition provided by the tax law of a "domestic building and loan association."

C. General explanation of provision

1. Additions to reserves for losses on loans.—In the case of mutual savings institutions the bill provides new rules for calculating the deduction allowable for additions to bad-debt reserves, or "reserves for losses on loans" as they are referred to in the bill. Beginning in 1963, these institutions will maintain two accounts to which additions will be made in the future with respect to reserves for bad debts.[1] One of the two accounts is a reserve for "losses on qualifying real property loans," the additions to which can be determined by the taxpayer under rules set forth in the bill. The other is a reserve for "losses on nonqualifying loans."

Additions to this latter account are required to be "reasonable additions," which means that, as in the case of other taxpayers, additions to these reserves will be determined upon the basis of the past experience and other appropriate factors.

In the case of the reserve for losses on qualifying real property loans, the addition to be made each year to this reserve is to be determined by the taxpayer but may not exceed whichever of the following is the largest:

(*a*) 60 percent of the institution's taxable income for the year computed before this deduction (minus the amount added to the reserve for losses on nonqualifying loans). This may not exceed an amount necessary to increase the balance of the reserve for losses on qualifying real property loans to 6 percent of these loans. Also, in the case of stock savings and loan associations, the deduction, instead of being 60 percent of taxable income, is to be 50 percent of this income;

(*b*) the amount necessary to increase the balance in the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year. For new mutual (but not stock) companies (in their first 10 years of existence) this 3 percent is increased by 2 percent, but only with respect to loans not in excess of $4 million (a maximum special reserve addition of $80,000);

(*c*) if the institution demonstrates the need for greater reserves than are permitted under (*a*) or (*b*) above, an amount which would be permitted to be added to the reserve for losses

[1] They may also have a supplemental reserve which will represent certan reserves built up in the period from 1952 through 1962. This supplemental reserve is explained below.

on qualifying real property loans without regard to the special provision for mutual savings institutions.

Your committee's amendments provide that the total amount added to the reserve for losses on qualifying real property loans (determined under (a), (b), or (c) above) plus the amount added to the reserve for losses on nonqualifying loans may not exceed the amount which brings the combined balance of these reserves and surplus, undivided profits and reserves (whether accumulated before or after December 31, 1951), to an amount equal to 12 percent of total deposits (or withdrawable accounts).

When losses on loans are realized they will be charged to the appropriate account within the general reserve for bad debts. That is, losses on loans with respect to qualifying real property will be charged to the reserve for such loans and losses on nonqualifying loans will be charged to the reserve for losses on such loans.[2]

The reserves which are required by the bill to be established—that is, the reserve for losses on qualifying real property loans, the reserve for losses on nonqualifying loans, and the supplemental reserve for losses on loans—are required to be treated as bad-debt reserves for all tax purposes (except that no deduction is allowed for any addition to the supplemental reserve). Thus, although these reserves are termed reserves for "loans," they are reserves for bad debts; and any charge to any such reserve for an item other than a bad debt will result in the inclusion in gross income of an amount equal to such charge.

For purposes of determining annual additions to the reserve for losses on qualifying real property loans, mutual savings institutions are to take into account all loans secured by improved real property (whether such loans are insured or uninsured) except Government bonds, certain corporate obligations and certain loans between banks and related parties. Under this provision, both federally insured FHA and guaranteed VA home loans, as well as conventional loans, may be taken into account in determining the amount of additions to the reserve for losses on qualifying real property loans. Loans on improved real property are intended for this purpose to include loans obtained for the construction of improvements on real property, even though at the time the loan is made no improvements may exist on the property.

The following examples illustrate the operation of the alternative choices for additions to reserves for bad debts:

Example 1: At the close of its taxable year, X, a mutual building association in existence for more than 10 years, has improved real property loans outstanding of $2,000 and nonqualified loans of $200. Its taxable income before any addition to a reserve for bad debts is $50. The balance in its reserve for losses on improved real property loans is $51 and the balance in its reserve for losses on nonqualifying loans is $1. (Its experience indicates the need for a reserve for losses on nonqualifying loans of 1 percent of such loans, and a reserve for losses on improved real property loans of 2.5 percent of such loans.)

For this year X would be permitted to add to its reserves $30 (60 percent times $50). (Under the 3-percent method only $10 could have been added, $1 to the nonqualifying loan reserve and $9 to the qualifying loan reserve.) Of this amount, $1 would be added to the

[2] At the election of the taxpayer, losses on any loan instead of being charged to the reserve referred to above may be charged in whole or in part to the supplemental reserve for losses on loans referred to below.

reserve for losses on nonqualifying loans (making the balance in that account \$2) and \$29 would be added to the reserve for losses on improved real property loans (making the balance in that account \$80). Taxable income for this year would then be \$20.

Example 2: Assume the same facts, except that taxable income before any addition to reserve for bad debts is \$15. X would be permitted to add to its reserves \$10. This is the amount necessary to bring the balance of the reserve for losses on nonqualifying loans to \$2 (1 percent times \$200) plus the amount necessary to bring the balance of the reserve for losses on improved real property loans to \$60 (3 percent times \$2,000). (Under the 60-percent method the addition would have been only \$9.) Taxable income would then be \$5 (\$15 minus \$10).

2. Treatment of pre-1963 reserves.—At the present time bad-debt reserves, etc., of mutual savings banks on the average are about 10 percent of their deposits, while similar reserves of domestic building and loan associations average about 8 percent of deposits. This means that existing reserves of these mutual savings institutions in most cases will exceed 3 percent of qualifying real property loans, plus a reasonable reserve for other loans.

The bill makes special provision for the treatment of existing bad-debt reserves of mutual savings institutions. If the entire amount of such reserves (called "pre-1963 reserves" in the bill) were required to be allocated to the reserve for losses on qualifying real property loans and to the reserve for losses on nonqualifying loans, the balances of those reserves would in many cases be so large that many mutual savings institutions would be denied a deduction for additions to bad-debt reserves for many years. In order to mitigate this effect, your committee's bill provides that only a portion of such pre-1963 reserves is to be allocated to the reserve for losses on qualifying real property loans and to the reserve for losses on nonqualifying loans, under the following rules:

(*a*) First, there is credited to the reserve for nonqualifying loans whatever portion of these pre-1963 reserves is necessary to bring the balance of this reserve to an amount which would be reasonable on the basis of nonqualifying loans outstanding as of December 31, 1962;

(*b*) Next, there is credited to the reserve for losses on qualifying real property loans whatever remaining portion of the pre-1963 reserves is necessary to bring the balance of this reserve up to 3 percent of loans on improved real property outstanding as of December 31, 1962, or to a greater amount if the experience of the institution as of December 31, 1962, indicates a need for a greater reserve; and

(*c*) Finally, any remaining pre-1963 reserves are credited to the supplemental reserve for losses on loans.

Amounts credited to the supplemental reserve for losses on loans can be used only to offset losses on loans (if the institution chooses to charge losses to this reserve). Any other use of this reserve will result in the inclusion in gross income of the charge. In determining the amount of these pre-1963 reserves the House bill provided that accumulations in reserves were to be taken into account only for years after December 31, 1951. Your committee's amendments provide that pre-1952 reserves also are to be taken into account in establishing the 3-percent opening balance in the reserve for qualifying real property loans, but that the amount added to the reserves attributable to this pre-1952 period may be distributed to depositors or otherwise used by the institution so long as this amount continues to be taken into account in determining the balance at any time in this fund.

3. Distributions to shareholders.—Some of the savings and loan associations to which this provision is applicable have shares of stock outstanding (which are not withdrawable shares). The bill provides that in the case of distributions to these stockholders, the amounts are to be considered as paid out of the following funds of the institution:

(*a*) First, out of earnings and profits accumulated in taxable years beginning after December 31, 1951;

(*b*) Then out of the reserve for losses on qualifying real property loans (but only to the extent the balance in this reserve exceeds the amount which would have been allowed the institution in the absence of the special reserve provision);

(*c*) Next out of the supplemental reserve for losses on loans; and

(*d*) Finally, out of other amounts.

Before distributions can be made out of either the reserve for losses on qualifying real property loans or out of the supplemental reserve, the amount required to be charged by the stock institution must be included in its gross income for tax purposes. The amount required to be charged to either of these reserves and included in income is the amount of the distribution to the stockholder "grossed-up" by the appropriate amount of tax. These special rules will insure that any amount distributed to stockholders out of amounts charged to these reserves which was not previously taxed will be subjected to the regular corporate income tax at the time of distribution.

4. Foreclosures on property securing loans.—The bill also adds a new provision to the code containing rules to govern the tax consequences of mortgage foreclosures (or other similar proceedings) in which a mutual savings institution takes over property which was security for its loan. Under existing law the foreclosure event is considered a taxable transaction. This has been interpreted to mean that a bad-debt deduction may or may not arise at that time, depending upon the relation of the bid price of the property to the amount of the loan outstanding. Where the foreclosed property is bid in for the amount of the loan a bad debt deduction may not be taken under present law; however, a gain or loss may result at the time of foreclosure if the fair market value of property foreclosed is different from the price at which it was bid in. When the property is subsequently sold by the mutual savings institution, it may realize a further gain or loss on such disposition. Whether the gains and losses at the time of foreclosure and at the time of ultimate disposition are capital or ordinary gains and losses depends on the nature of the activities of the institution at each such time.

The bill seeks to avoid these erratic results by providing that in the future a foreclosure is not to be treated as a taxable event, and that amounts received by the mutual savings institution subsequent to the foreclosure are to be treated as payments on the indebtedness. This would be accomplished under the bill by treating the property received in a foreclosure (or other proceeding) as having the same characteristics as the debt for which it was security. Thus, for bad-debt (or loss) purposes the act of foreclosure will not create a taxable occasion; however, if the property has depreciated in value, the decline may be charged against the bad-debt reserve as a partially worthless debt. If it continues to decline in value, additional charges may be made against the reserve.. When the property is ultimately sold or disposed of, the difference between any amount realized and the original or previously reduced debt, is to be treated as ordinary loss or income and is to be charged, or credited, as the case may be, against the reserve for losses on qualifying real property loans. Because the foreclosed property is to have the same characteristics as the indebtedness, where property is rented by the mutual thrift institution after foreclosure, no depreciation deduction is to be permitted. However, as explained above, if the property actually depreciates in worth (as contrasted to a mere decline in book value), a charge may be made against the reserves.

5. Definition of domestic building and loan association.—Under present law "domestic building and loan association" is defined to mean a—

> domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association, substantially all of the business of which is confined to making loans to members.

Problems have arisen with this definition because loans in many cases now are in substance not loans made to members. It is understood that technical conformance has been maintained with the membership requirement of present law by making borrowers of funds members of the institutions. However, questions have arisen as to the substance of such provisions.

As a result, your committee has concluded that the definition of a domestic building and loan association, eligible for the tax treatment described above, should be brought more nearly into conformance with actual practice. At the same time it was deemed desirable to restrict this tax treatment to those primarily engaged in making residential real estate loans, with special emphasis on 1- to 4-family units, and omitting from the definition cases such as those where these institutions have been used for speculative purposes.

In view of these considerations, your committee has redefined a domestic building and loan association to mean a building or savings and loan association which is an insured institution within the meaning of section 401(a) of the National Housing Act or one which is subject by law to supervision and examination by State or Federal authority having supervision over such associations. In addition, however, the bill provides that an institution in either of these groups qualifies only if substantially all of its business consists of accepting savings and investing in loans secured by or for the improvement of real property of the type described below. This restriction will, of course, prevent such a savings institution from carrying on the business of brokering mortgage paper if this represents any substantial part of its business. It is not intended, however, that this prevent necessary borrowings from Government agencies such as HOLC.

A third restriction on qualified domestic building and loan associations requires them to invest at least 90 percent of their assets in—

(*a*) Cash,

(*b*) Obligations of the United States or of a State or local government and stock or obligations of a corporate instrumentality of the United States or of a State or local governmental unit,

(*c*) Loans secured by an interest in real property including so-called improvement loans,

(*d*) Loans secured by a deposit (or share) of a member, and

(*e*) Property acquired through default of real property loans.

Of the 90 percent of total assets referred to above, at least 80 percent (72 percent of total assets) must be invested in residential real property loans (including improvement loans for such property and tract loans which will be used for such property) or in cash or Government obligations (referred to in (*a*) and (*b*) above). In addition, at least 70 percent of this 90 percent of total assets (63 percent of total assets) must be invested in residential real property representing 1- to 4-family units (or loans made for the improvement of such property or tract loans on such property) or in cash or Government obligations (as referred to in (*a*) and (*b*) above). The bill also provides that no more than 18 percent of the total assets of an association may be invested in other than residential real property loans, cash, and Government obligations except to the extent that cash and governmental obligations are less than 10 percent of total assets. Similarly the bill provides that no more than 27 percent of the total assets may be invested in other than 1- to 4-family-unit residential real property loans, cash, and Government obligations, again except to the extent that cash and Government obligations are less than 10 percent of total assets. One further requirement provides that none of the assets of the association may be invested in stock of any corporation other than stock of a corporate instrumentality of the United States, a State or local governmental unit, or stock acquired through defaults.

6. *Repeal of certain excise tax exemptions.*—Under present law, Federal savings and loan associations are exempt from the excise taxes on communications and the excise tax on transportation of persons. These exemptions were granted by the Home Owners' Loan Act of 1933. Your committee's version of the bill repeals these exemptions effective as of December 31, 1962. In addition, the amendments made by your committee delete the exemptions from the documentary stamp taxes on stocks and certificates of indebtedness under existing law in the case of domestic building and loan associations, savings and loans associations, cooperative banks, and homestead associations. The exemption from the stock issuance or transfer taxes is continued, however, in the case of domestic building and loan associations and cooperative banks insofar as these taxes relate to stock representing deposits or withdrawable accounts.

7. *Deduction for dividends paid on deposits.*—Your committee has also provided for a deduction for dividends or interest paid by savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law even though they do not come within the definition of domestic building and loan associations. This deduction is available only in the case of amounts paid to depositors or those having withdrawable accounts.

8. *Effective date.*—The new rules provided by the bill for additions to reserves for bad debts are to apply to taxable years ending after December 31, 1962. However, the bill provides a special rule to deal with fiscal years where a taxpayer has a year which begins in 1962

and ends in 1963. The effect of this special rule is to continue the rules under existing law up to the end of December 1962, and to apply the new rules as of January 1, 1963.

The tax treatment provided for property acquired in mortgage foreclosure proceedings is to apply to transactions occurring after December 31, 1962, in taxable years ending after that date. The new definition of domestic building and loan associations is to be effective for taxable years beginning after the date of the enactment of the bill. The repeal of the exemptions from excise taxes on communications and on transportation of persons in general is made effective as of January 1, 1963.

VII. DISTRIBUTIONS BY FOREIGN TRUSTS

(Sec. 7 of bill and secs. 643, 665, 666, 668, 669, 6047, 6677, and 7701 of code)

A. Reasons for provision

Certain tax avoidance possibilities exist under present law in connection with foreign accumulation trusts created by U.S. citizens or residents. The avoidance device involves the establishment of trusts for the benefit of U.S. beneficiaries by a U.S. grantor (or settlor) in a foreign country where the income of such trust is subject to little or no tax. The trust corpus may consist of foreign securities so that the income can be accumulated in the trust free of any U.S. tax for any number of years. In addition since these trusts are formed in countries which impose little or no tax on such income, no tax at all is likely to be paid. When the trust terminates and distributes the accumulated income and corpus to the U.S. beneficiaries, such distributions may be subject to no U.S. tax, or be subject to tax on only a small portion of the distributions.

Under present law, where a domestic trust is established for the purpose of accumulating income for a period of years the trustee pays a tax currently on the income accumulated at the same rates applicable to individuals. In general, when a beneficiary receives a distribution from the trust, in excess of the currently distributable net income (if the amount exceeds $2,000), it is taxed to him to the extent it represents income accumulated by the trust in any of the preceding 5 years. The tax on such amounts is payable currently, but is computed as if the beneficiary had received a distribution of this income in each of these 5 prior years in which the income was earned, with a credit being allowed for the taxes paid by the trust with respect to such income.

The above rule, known as the "5-year throwback rule", is also applicable to distributions made by foreign trusts to U.S. beneficiaries. However, it frequently does not result in a tax on the distributions. First of all, it does not in any case apply to any income accumulated for more than 5 years. In addition, there are a number of exceptions making distributions nontaxable to the beneficiaries even where they are attributable to the 5 immediately preceding years. For example, the 5-year throwback rule does not apply to accumulations for the benefit of a minor beneficiary; accumulations distributed to a beneficiary upon reaching a specified age if not more than four such distributions can be made or the distributions are at least 4 years apart; and distributions to a beneficiary where a trust terminates and makes a final distribution which occurs more than 9 years after the date of the last transfer to the trust. As a result of these exceptions, and the 5-year limitation, it is relatively easy for U.S. grantors or settlors to establish foreign trusts in such a way that they pay little or no tax on trust income and which upon termination make distributions to American beneficiaries with little or no U.S. tax being paid.

In the last Congress, a bill (H.R. 9662) which was passed by the House, but on which action was not completed by the Senate, contained an amendment added by your committee designed to discourage the creation of foreign trusts for the purpose of avoiding U.S. tax. In addition, the Secretary of the Treasury in testimony last year recommended that with respect to existing trusts the law be modified so that distributions to a U.S. beneficiary from a foreign trust would be subject to tax in the year of distribution in an amount equal to the tax which would have been imposed had the income been distributed currently. This is in effect an extension of the existing 5-year throwback rule.

In view of the existing avoidance possibilities with respect to these foreign trusts, your committee agrees with the House that American beneficiaries of foreign trusts created by U.S. grantors, settlors or transferrors should be taxed in substantially the same manner as if the income had been distributed to the beneficiary currently as earned (although a "shortcut" method of computation may be elected by the taxpayer in place of this more "exact" method). This provision is not viewed by your committee as imposing a penalty but rather as a method for placing U.S. beneficiaries of foreign accumulation trusts created, or added to, by Americans in substantially the same way as the beneficiaries of domestic trusts distributing their income currently.

B. Comparison of committee amendments with House provision

With the exception of the two relatively minor amendments described below, your committee's bill retains the provision of the House bill without change.

The attention of your committee was called to the fact that under the House bill where there was a foreign trust to which both U.S. persons and foreign persons contributed money or property, a U.S. beneficiary receiving a distribution from such a trust would be taxable on the entire amount of the accumulated income. It is believed that the purpose of the provision was to subject to taxation distributions from foreign trusts only to the extent that the corpus was contributed by U.S. persons. Accordingly, your committee's bill amends the definition of the term "foreign trusts created by a U.S. person", so that it will apply only to the extent that money or property is transferred (directly or indirectly) by a U.S. person, or under the will of a decedent who was a U.S. citizen or resident at the time of his death. Hence, where a foreign trust is created to which U.S. persons and foreign persons both contributed money or property, the U.S. beneficiary will be taxed only to the extent the distribution is attributable to money or property (including earnings thereon) contributed by the U.S. person.

Under the House bill, the new provisions would apply with respect to distributions made in taxable years of trusts beginning after the date of enactment of this bill. In the case of a calendar year foreign trust, the new rules would not be applicable to distributions made prior to the end of the current year, whereas they may apply sooner to foreign trusts operating on a fiscal year basis. In order to equalize the tax consequences with respect to all foreign trusts, your committee amended the effective date provision to make the new rules applicable with respect to all distributions made after the date of enactment of the bill.

C. General explanation of provision

The bill, as amended by your committee, provides for taxing American beneficiaries on distributions received from foreign trusts which are created by U.S. grantors, settlors, or transferors in substantially the same manner as if the income had been distributed to the beneficiary currently as earned, instead of being accumulated in the trust. The bill, in effect, eliminates the 5-year limitation and all the exceptions applicable to domestic trusts, and provides an unlimited throwback rule with respect to distributions from foreign trusts. However, only distributions of income accumulated after the effective date of the 1954 Code will be subject to the new provisions.

The new provision applies to foreign trusts to the extent money or property has been transferred, directly or indirectly, by U.S. persons or under the will of a decedent who was a U.S. citizen or resident. A foreign trust for this purpose is one the income of which from sources without the United States is not includible in gross income for U.S. tax purposes. The term "U.S. persons" as used here includes U.S. citizens or residents, domestic partnerships and corporations, and estates and trusts.

In the case of these foreign trusts, all of their accumulated income, other than income distributable currently, upon distribution to a U.S. citizen or resident is to be taxed to him. The amounts distributed to the U.S. beneficiary are treated as if they had been distributed in the preceding years in which income was accumulated, but are includible in income of the beneficiary for the current year. However, under the bill the tax on such amounts may be computed, at the election of the beneficiary in either of two ways. One method, referred to here as the "exact" method, is substantially the same as the method provided under present law in the case of distributions subject to the "5-year throwback rule." The other is a "shortcut" method which the beneficiary may elect if he does not desire to go through the more extensive computations required by the exact method.

Under the exact method of computation, the tax on the amounts distributed cannot exceed the aggregate of the taxes that would have been payable if the distributions had actually been made in the prior years. This method requires complete trust and beneficiary records for all past years, so that the distributable net income of the trust can be determined for each year, as well as the years in which trust income was accumulated. The beneficiary's own tax then is recomputed for these years, including in his income the appropriate amount of trust income for each of the years (including his share of any tax paid by the trust). Against the additional tax computed in this manner the beneficiary is allowed a credit for his share of the taxes paid by the trust, including a foreign tax credit for income taxes paid foreign countries. Any remaining tax then is due and payable as a part of the tax for the current year in which the distribution was received.

The so-called short-cut method in effect averages the tax attributable to the distribution over a number of years, equal to the number in which the income was earned by the trust. This is accomplished by including, for purposes of tentative computations, a fraction of the income received from the trust in the beneficiary's income for the current year and each of the 2 immediately prior years.[1] The fraction of the income included in each of these years is the same as the number of years in which the income was accumulated by the trust. Thus if the accumulated income is attributable to 10 different years (although the trust may have been in existence over longer than a 10-year period, however), then one-tenth of the amount distributed would be included in the income of the current year and one-tenth in each of the 2 prior years. The additional tax is then computed with respect to these 3 years and the average additional tax for the 3 years determined. This average is then multiplied by the number of years to which the trust income relates, namely 10 in the example used here. The tax so computed may be offset by a foreign tax credit for any foreign taxes paid by the trust and any remaining tax liability is due and payable in the same year as the tax on the beneficiary's other income in the year of the distribution.

The bill provides certain exceptions from the two computation methods outlined above. First, if the shortcut method is used and the number of trust years to which the income relates is less than 3, then the average is determined on the basis of any smaller number of years to which the distribution actually relates. Second, if the beneficiary was not yet born, with respect to a year to which part of the trust income which is distributed relates, the so-called exact method of computation is not to be used. Similarly, where the beneficiary was not alive for the full 3-year period in which the shortcut averaging device is applied, then this averaging device is to be computed on the basis of the shorter period in which the beneficiary was in existence. Third, the bill specifies how prior distributions from foreign trusts to the beneficiary are to be treated in making these computations. Where a taxpayer with respect to an earlier distribution has used the shortcut method and subsequently uses the exact method for another distribution, for purposes of this exact computation any income received from the trust in the earlier distribution must be included in his income for any year to which the second distribution relates. However, where in the current distribution the taxpayer is using the so-called shortcut method, he is not required to take into account prior distributions from a foreign trust, whether the exact or shortcut method of taxation was used in the prior computations.

As under present law, the methods of tax computation outlined above are substitutes for including and taxing the entire amount of the distribution in the year actually received. To take advantage of either method the beneficiary at the time of making the election must supply such information with respect to the operation and accounts of the trust for each of the years in which an amount is considered distributed as the Secretary or his delegate may by regulation pre-

[1] The 2 prior years are included for this purpose only to prevent the current year, in whicht here may be special circumstances, from having too great an influence on the averaging device used.

scribe. This information is necessary in order to give assurance that the computation is made correctly.

So that the Internal Revenue Service will be aware of the existence of foreign trusts created by American grantors, settlors or transferors, the bill provides that the grantor of an inter vivos trust or the fiduciary of an estate in the case of a testamentary trust, or the transferor is to make a return within 90 days after the creation of the foreign trust or the transfer of money or property to it by an American person, setting forth such information with respect to the foreign trust as the Secretary or his delegate prescribes by regulation as necessary to carry out the provisions of the income tax laws. Failure to supply the information, unless it can be shown that this failure is due to reasonable cause, is to result in a civil penalty (in addition to any criminal penalty presently provided by law) equal to 5 percent of the amount transferred to the trust but not to exceed $1,000. A similar penalty applies with respect to a return which does not show the information required, even though the return itself is filed.

Generally, these provisions relating to foreign trusts are to apply to distributions made after the date of enactment of this bill. The provisions relating to returns with respect to the creation of, or transfers to, a foreign trust, the civil penalties relating to these returns, and the definitions of U.S. persons and foreign estates and trusts are to be effective on the date of enactment of the bill.

VIII. MUTUAL FIRE AND CASUALTY INSURANCE COMPANIES, ETC.

(Sec. 8 of the bill and secs. 821–826, 831, and 832 of code)

A. *Reasons for provision*

Stock fire and casualty insurance companies have long been taxed at ordinary corporate income tax rates on both investment income and underwriting income. Mutual fire and casualty insurance companies, on the other hand, since 1941 have paid tax under special formulas which do not take into account their underwriting income or loss. Generally, these mutual companies presently are taxed under whichever of two formulas results in the higher tax. Under one formula, they are taxed at ordinary corporate income tax rates on investment income only. Under the other, they pay a tax of 1 percent on their gross investment income plus their premium income after policyholder dividends. Reciprocal underwriters and interinsurers are taxed only on their investment income and they have a vanishing $50,000 exemption. Mutual companies with total receipts of not more than $75,000 are tax exempt.

The President recommended that stock and mutual fire and casualty insurance companies be taxed on the same basis. He proposed that mutual companies pay tax on their underwriting profits, as well as on their investment income, substantially in the same manner as stock companies.

This bill to a considerable degree achieves the result sought by the President. Under it, mutual fire and casualty insurance companies are taxed under a modified total income formula. The modifications are required because of the special circumstances of the mutual companies.

While a stock insurance company can pay extraordinary losses not only out of its accumulated profits but out of its paid-in capital' a mutual insurance company can pay extraordinary losses only out of retained underwriting income. As a result, a mutual ordinarily retains a portion of its underwriting income each year for this purpose; the remainder is paid to its policyholders as policy dividends. This accumulated underwriting income constitutes its reserve out of which insurance losses can be paid, and the existence of such reserves is an important protection to the mutual policyholders.

Under the law up to this time, no income taxes have been paid on this retained underwriting income, except (since 1941) to the extent the excess of the alternative 1-percent tax over the tax on investment income in effect taxed part (all, or more than all) of the underwriting income. Similarly, underwriting losses may not reduce the tax on investment income. Under the President's proposal, underwriting gains would have been fully taxed as realized. Under the provisions of this bill, however, these mutual fire and casualty companies will be permitted to set aside a portion of each year's underwriting gain in a special account for protection against losses. This amount will be available to meet certain losses for 5 years, after which most of any remaining portion will be included in taxable income of the sixth year. A small portion, however, will still be retained in the special account to take care of extraordinary losses. Eventually, these companies will pay tax on their total income, but the tax deferral formula of the bill gives recognition to the mutuals' lack of access to the capital market for funds with which to pay losses. Under the bill underwriting losses, other than losses created by the special protection against loss deduction, will reduce the tax on investment income.

Under the bill mutual companies which have substantial underwriting gains will pay larger taxes than under present law. However, the full impact of taxing their underwriting income will be delayed until 1968. Thus, for a 5-year period only a portion of underwriting income of the mutual fire and casualty industry will be exposed to the Federal income tax. Thereafter, most of the amounts in the account which are not used for the payment of losses within 5 years will be taxed, but this will be offset—or more than offset if the company is growing and its underwriting income is increasing—by the portion of the income of the sixth and subsequent years which is set aside in the protection against loss account.

On the other hand, mutual fire and casualty companies having underwriting losses will, for the first time, be permitted to deduct these losses in full. For such companies the tax under the bill will be less than under present law which taxes the investment income of a mutual company at full corporate rates even though there is an underwriting loss. On the other hand, a stock company is taxed only on the net amount after deducting an underwriting loss against investment income. This inequality of treatment should not continue. Under this bill an underwriting loss would, depending on the circumstances, be offset against either investment income or the protection against loss account, or both, and any loss not so absorbed would be carried back (though not to a year before 1963) or carried forward, as in the case of corporations generally.

B. Comparison of committee amendments with House provision

Your committee has approved the basic provisions of the House bill taxing mutual fire and casualty insurance companies on their underwriting profits. Under both the House bill and your committee's bill, a portion of underwriting income is permitted to be set aside for a 5-year period for the purpose of offsetting insurance losses. The remainder will be currently taxed.

However, your committee modified the House bill to eliminate a discrimination in the manner in which losses are to be charged by mutual companies. Under the House bill, a mutual fire or casualty insurance company operating on a "deviated premium" basis (under which, in effect, policyholder dividends are deducted in advance of the policy period and only the net amount is charged for a policy) was permitted to charge all its underwriting losses (other than those created by the protection against loss deduction) directly against investment income. A dividend-paying mutual, on the other hand, even though its net premium at the end of the year (after payment of policyholder dividend) was identical to that charged by the deviating company, would have been compelled to reduce the underwriting loss chargeable to investment income by the amount of the policyholder dividends.

The effect of this discrimination was that in loss years the deviating company could charge larger amounts of underwriting loss to investment income and retain its protection against loss account, while a dividend-paying company was permitted to charge lesser amounts of underwriting loss to investment income and was required to deplete its protection against loss account more rapidly by charging to it not only losses created by the protection against loss deduction but also losses created by the payment of policyholder dividends. Since these dividends are viewed solely as price adjustments in the cost of insurance, your committee feels the tax consequences should be the same regardless of whether the price of the policy is adjusted at the time the policy is sold (by means of a deviated premium) or at the end of the policy period (by means of a policy dividend).

To eliminate this discrimination and to place mutual companies on a basis more comparable to stock companies (which are permitted under existing law to charge underwriting losses created by dividends directly against investment income), your committee's bill permits underwriting losses arising from the payment of policy dividends (price adjustments) to be charged first to investment income with any remaining unused losses then being charged to the protection against loss account.

Some mutual insurance companies specialize in insurance against limited risks such as windstorm, hail, or flood, in relatively small geographical areas. Because their operations cover a small area, few storms or floods may occur in some years and the company will then have relatively large underwriting gains; in other years, storms may cause heavy damage in the area of operations and the company will have relatively large underwriting losses. To compensate for this uneven experience both the House and your committee's bills permit these concentrated risk companies to defer, in the protection against loss account, a greater proportion of underwriting income than is permitted for ordinary companies. This is to protect them against unusually large losses if, and when, such losses occur.

Your committee has amended the House provision relating to the concentrated risk companies in two respects. Both are concerned with the qualification of companies for the additional protection against loss deduction. Under the House bill, a concentrated risk company was one which derived more than 50 percent of its premium income from insuring in one State against losses arising from wind, hail, floods, etc. Your committee believes that a company which has 40 percent of its premium income from such risks assumed in a limited area should also qualify as a concentrated risk company. Accordingly, the percentage test has been reduced to 40 percent. In addition, in recognition that storms and similar hazards are not restricted by State boundaries, your committee has added an alternative area test to the one-State test of the House bill. Under this alternative test, if more than 40 percent of its premium income is from the specified risks arising within a circle having a 200-mile radius (a 400-mile diameter), the company will qualify.

Under existing law, very small mutual companies, that is, companies whose total receipts from all sources (including premiums) do not exceed $75,000, are exempt from tax. The House bill did not alter this exemption. Your committee, however, has concluded that the $75,000 limitation on the exemption, which was provided in 1942, is totally inadequate by today's standards. To bring this exemption into line with current conditions, your committee's bill increases the limitation on the small company exemption to $150,000.

The House bill provided a special tax treatment for mutual companies with total receipts between $75,000 and $300,000. Companies in this category would have been treated much as they are under existing law; i.e., these companies would pay tax on their investment income only (however, the alternative 1-percent tax of present law would no longer apply).

Your committee has approved this provision of the House bill, but has amended the limitations. First, the minimum limit has been increased to $150,000 to coincide with the new limitation on exemption for the very small companies. The maximum limitation has been increased to $600,000 (from $300,000 in the House bill). This treatment is justified because these small companies often are of the assessment type and are not required to compute and report their underwriting income on approved forms for State insurance commission purposes. The bill makes it unnecessary for them to compute their underwriting income in the future. Moreover, this amendment will enable these small, often new, companies to maintain sufficient reserves so that they can obtain reinsurance at reasonable rates. Small companies with total receipts between $600,000 and $1,200,000 ($300,000 and $900,000 in the House bill) will be taxed both on their investment income and on their underwriting income. However, to provide for a gradual transition to the new tax on their underwriting income, like the House bill your committee's bill provides a special deduction of $6,000 which decreases as total receipts of the company increase above $600,000. This means that at $1,200,000 there is no special deduction.

Reciprocal underwriters and interinsurers differ from ordinary mutual insurance companies in that their business is conducted by two entities rather than one. An ordinary mutual insurance company receives all of the premium income from insurance and not only pays losses but conducts directly the operation and management of the insurance activities. The reciprocal underwriter or interinsurer, on the other hand, pays its insurance losses, but an "attorney-in-fact" performs all, or most, of the insurance functions—writing policies, collecting premiums, settling claims, keeping records, etc.—and pays the related expenses, for a portion of the premium income of the reciprocal. Profits realized by the attorney-in-fact from conducting these insurance operations are taxed as ordinary income. However, if that income were earned by a mutual insurance company which performed these operations itself, under existing law it would constitute underwriting income and would not be taxed. Moreover, under present law reciprocal underwriters and interinsurers are not taxed in the same way as ordinary mutuals since they are not subject to the alternative 1-percent tax and have a special exemption. The House bill taxes reciprocal underwriters and interinsurers under the same rules that apply to ordinary mutuals; but in recognition of their unique form of operation it permits them in effect to combine the underwriting income of the attorney-in-fact with their own for the purpose of offsetting certain losses. This provision has been approved with a change which permits the reciprocal to use the combined underwriting income as the basis for setting aside 25 percent of underwriting income in the protection against loss account; thus, in effect, increasing the amount of its own underwriting income upon which tax may be deferred.

Under present law, factory mutual insurance companies are taxed under the same formulas as other mutuals; that is, they pay tax on investment income only (with no deduction for underwriting losses) or under the alternative 1-percent formula. However, because of the very large premium deposits required of their policyholders (typically up to 10 times the amount of an ordinary premium) the investment income of such companies is very large. As a result in practice they never become subject to the alternative 1-percent tax. As in the case of other mutuals, these companies are not permitted to deduct their underwriting losses. This has been a handicap to these companies in years in which they have losses, because the industrial risks which they insure generally are quite large. The House provision, approved without change by your committee, taxes factory mutual companies as if they were stock companies, thus permitting them to deduct underwriting losses when they occur. However, since a large portion of each premium is in effect a deposit (which may be returned to the policyholder), in computing their underwriting profits these companies are to be permitted to determine their premium income on the basis of their schedules of absorbed premium deposits. The amount so determined will be increased by 2 percent for income tax purposes to offset the advantage of the temporary use of deposits which would ordinarily be viewed as premiums received.

Your committee added two new provisions to the House bill. One of these deals with mutual flood insurance companies. It was brought to the committee's attention that some mutual flood insurance companies (including reciprocal exchanges) operate on a premium deposit system quite similar to that employed by factory mutual fire insurance companies. Because of the similarity of their method of operation, your committee has concluded that these companies should be taxed in the same manner as factory mutual fire insurance companies. Accordingly, your committee has amended the House bill to provide that mutual flood insurance companies are to be taxed under the rules also made applicable by this bill to factory mutual fire insurance companies. Under these rules these flood insurance companies are to determine their underwriting income on the basis of their schedule of premium absorptions. Of course, these companies will also be required to increase the amount of their absorbed premiums by 2 percent of the amount actually absorbed.

The second amendment provides that a mutual company which experienced underwriting losses in each of 5 out of the 6 years immediately preceding 1963 is to be provided a special 5-year carryover of the excess of underwriting losses over underwriting gains during the 6-year period. This exception to the general rule of the bill that underwriting losses may not be carried over from a year prior to 1963 will prevent a company with a long history of unusual loss experience from being penalized in years when it is retaining unusual amounts of underwriting income to restore its reserves to their normal level, particularly when the underwriting losses were not permitted to be taken into account in computing taxable income in the 6-year period. In cases cited to the committee, to which this provision applies, some mutual insurance companies actually paid taxes for the 6-year period in excess of total income for that period.

C. General explanation of provision

Under present law the tax on a mutual fire and casualty insurance company is, in general, the greater of (1) a tax at the ordinary corporation rates on the company's net income from investments, or (2) a tax of 1 percent of its gross income from both investments and premiums less dividends to policyholders. Under the provisions of this bill the 1-percent alternative tax is eliminated, and the tax is computed at the ordinary corporation rates on the company's total income (investment income and underwriting income) less amounts temporarily set aside in a protection against loss account. Underwriting income of these insurance companies is the excess of earned premiums over insurance losses and expenses incurred and dividends paid to policyholders.

There are special provisions for companies with concentrated risks, for small companies, and for reciprocals or interinsurers. The bill also removes the factory mutuals from the treatment accorded mutual casualty companies generally, and treats them as if they were stock companies, with special provisions for determining what portion of their premium deposits is to be viewed as earned premiums.

1. Ordinary mutual fire and casualty insurance companies.—Under the bill taxable income of mutual insurance companies will consist of taxable investment income, statutory underwriting income, and certain amounts previously set aside for protection against losses. Statutory underwriting income, as used in the bill, is underwriting income after a special deduction for protection against losses of an amount equal to 1 percent of insurance losses incurred during the year and 25 percent of the ordinary underwriting income.

An amount equal to the special deduction is to be set aside for 5 years in a "protection against loss" account where it can be used only for offsetting losses. After the fifth year, if the amount credited to the protection against loss account has not been absorbed by losses, the portion attributable to the 1 percent of losses and one-half of the portion attributable to the 25 percent of underwriting income will be withdrawn from the account and included in taxable income. The other one-half of the amount representing the 25 percent of underwriting income is retained in the account for a longer period as a cushion against extraordinary losses.

The bill limits the amount which may be accumulated in this account, however. The amount in this account may not be increased above an amount which at the end of any year is more than 10 percent of the earned premiums less dividends to policyholders for that year. If a greater amount were already in the account at the beginning of the year, the account would not be reduced (because of the ceiling) below this amount.

If in any year there is a loss from underwriting instead of a gain, the part of the loss resulting from the payment of insurance claims and expenses and policy dividends would be offset directly against taxable investment income. Any amount not so offset and other losses (those resulting from the special protection against loss deduction) would be charged against the protection against loss account on a first-in, first-out basis. Losses charged against the account would be applied proportionately to amounts representing the 1 percent of losses incurred and the 25 percent of underwriting income.

If in any year there is an extraordinary underwriting loss—more than the investment income for that year and the entire amount in the protection against loss account—the excess will be treated much like an ordinary net operating loss, to be carried back against the taxable income of the 3 preceding years or carried forward (first against amounts added to the protection against loss account and then against otherwise taxable income) to the succeeding 5 years, as in the case with any corporation.

In computing their taxable income, mutual companies are to be allowed an unlimited deduction for dividends paid to policyholders, just as stock companies may take unlimited deductions for their policy dividends.

Under present law, mutual insurance companies which are not subject to the 1-percent alternative tax are allowed a special exemption of $3,000, with the tax on taxable incomes between $3,000 and $6,000 gradually increasing until the exemption completely vanishes when taxable income reaches $6,000. The bill increases this special exemption (applicable to the new total of investment and underwriting income) to $6,000 in the case of mutual companies taxable under the general rules of the bill. There also is a gradually increasing tax on taxable incomes between $6,000 and $12,000, so the exemption vanishes when taxable income reaches $12,000.

2. Example.—The computation of taxable income, statutory underwriting gain and the protection against loss account for a 6-year period with successive underwriting gains, may be illustrated as follows, assuming the simplified facts as shown in the following table:

Year	Taxable investment income	Underwriting income	Insurance losses incurred	Additions to protection against loss account
1963	$10	$12	$700	$7+$3 ($10)
1964	11	16	800	8+ 4 (12)
1965	12	12	600	6+ 3 (9)
1966	13	20	600	6+ 5 (11)
1967	14	24	900	9+ 6 (15)
1968	15	20	1,000	10+ 5 (15)

For 1963 the statutory underwriting income would be $2, the underwriting income of $12 minus the 1 percent of incurred losses ($7) and the 25 percent of the underwriting income ($3) credited to the protection against loss account. The taxable income would be $12, the sum of the taxable investment income and the statutory underwriting income. For 1964 the statutory underwriting income would be $4 and the taxable income $15; for 1965 corresponding figures would be $3 and $15; for 1966, $9 and $22; and for 1967, $9 and $23.

For 1968 the statutory underwriting income would be $5 ($20 minus $10 minus $5), but there would be included in taxable income an amount equal to the first item added to the protection against loss account in 1963 ($7), and half of the second item ($1.5), so that for 1968 the taxable income would be $28.5, the sum of the taxable investment income ($15), the statutory underwriting income ($5), and the $8.5 withdrawn from the protection against loss account.

At the end of 1968, therefore, the total amount in the protection against loss account would be $63.5—amounts totaling $62 added for 1964 and the 4 following years which will be available to offset losses occurring during the next 5 years, and a residual $1.5 from 1963 to offset any loss which exceeded the entire amount in the account other than that.

If, in the preceding example, for 1966 there had been an underwriting loss of $30 (excluding the protection against loss deduction), and insurance losses incurred had still been $600 the deduction added to the protection against loss account would thus have been 1 percent of $600 or $6 and the statutory underwriting loss would be $36. In that case the portion of the loss not resulting from the protection against loss deduction ($30) would be offset against the taxable investment income of $13, the taxable income for 1966 thus being zero. The remaining portion of the loss ($23) would be charged against the protection against loss account, the $10 added to that account in 1963 and the $12 added in 1964 being eliminated, and of the 1965 addition there would remain $5.33 and $2.67. In that case there would be nothing from the protection against loss account to be included in taxable income for 1968 or 1969.

Under the bill, as passed by the House and approved by your committee, the rules applicable to mutual fire and casualty companies accruing market discount on bonds are changed. Under present law all mutual fire and casualty companies (and life insurance companies) are required to accrue each year a ratable portion of market discount on bonds and pay tax thereon at ordinary income tax rates (Rev. Rul. 60-210; 1960-1 CB 38). Stock fire and casualty insurance companies, on the other hand, are not required to accrue such discount but when the bond is sold or redeemed they are required to pay tax on the amount of gain resulting from market discount at capital gains rates (if the bond is held for more than 6 months). Since under the general rule of the bill the starting point in computing "mutual insurance company taxable income" is the gross income computed as if the taxpayer were a stock company, the effect is to treat market discount on bonds for mutual companies, other than the small companies taxable on investment income only) as it is treated by the stock companies.

3. Casualty companies with concentrated windstorm, etc., risks.—As stated above, most mutual insurance companies will report and pay a tax currently on the underwriting income remaining after transferring to the protection against loss account 25 percent of underwriting income plus 1 percent of incurred losses. With respect to certain insurance companies whose risks are primarily from losses from windstorm, hail, flood, earthquake, or similar natural hazard, and are concentrated in one State, or within 200 miles of any point selected annually by the taxpayer, the bill permits deferral of more than 25 percent of underwriting income. The percentage of underwriting income which can be credited to the account in such a case is determined by dividing the premiums earned on insurance contracts covering the risks in the designated area by total premiums earned by the insurance company. If this does not exceed 40 percent, the regular rule is used. If it does, the normal deduction of 25 percent of underwriting income is increased by the excess percentage points over 40 percent. Thus, under this rule, a company which has 80 percent of its windstorm, etc., risks insured in one State (or in a circle having a 400-mile diameter) would be permitted to transfer 65 percent (the regular 25 percent plus 40 percent) of its underwriting income to the protection against loss account. (However, concentration of risks will not serve to permit a larger percentage of incurred losses to be credited to the protection against loss account.)

The overall limitation on the protection against loss account of 10 percent of premiums less policy dividends for the year is not to apply to the amount of underwriting income in excess of 25 percent which these concentrated risk companies add to their protection against loss account. If it did apply it would defeat the objective of allowing a greater portion of underwriting income to be set aside. In applying the ceiling the concentrated risk company is to be treated as if it had transferred only 25 percent of its underwriting income to the account.

4. Small companies.—Under the bill, small mutual fire and casualty insurance companies (those whose total receipts—gross investment income, excluding capital gains, plus premiums—exceed $150,000 but do not exceed $600,000) are not taxed on underwriting income. As under present law, these companies will continue to pay tax on investment income only (with no deduction for underwriting losses) but the alternative 1-percent tax will no longer apply. The special exemption of $3,000, with the "notch" rates applying to taxable incomes between $3,000 and $6,000, also will continue in effect.

Despite the treatment for these small companies described above, the bill permits them to elect to be taxed on total income, including underwriting income, in the same manner as other mutual companies, and such an electing company will similarly be allowed to deduct underwriting losses. Presumably the existence, or expectation, of underwriting losses would be the primary reason for making this election. The election, once made, cannot be changed without the consent of the Treasury Department. On the other hand, a small mutual company which becomes taxable under the general rules because its gross investment income plus premiums exceed $600,000 in a taxable year, again will be taxed as a small company if its income falls below this level, if one condition is met. If, while it was taxed under the regular formula it was required to credit a portion of its underwriting income to the protection against loss account, this amount must be taken into income and a tax paid on it before the small company treatment will again apply. To provide consistent tax treatment for these small companies, the bill does not permit loss carrybacks or carryovers to be carried to, from, or over a year in which the company was taxable as a small company.

In the case of mutual fire or casualty insurance companies whose total receipts are between $600,000 and $1,200,000, the bill provides a special vanishing deduction which is to apply to underwriting income only. For a company whose total receipts are $600,000, the special deduction will be $6,000. As total receipts increase, the $6,000 deduction decreases and finally vanishes when total receipts of the company equal $1,200,000.

5. *Reciprocal underwriters and interinsurers.*—Under the bill, reciprocal underwriters and interinsurers are in general taxed in the same way as ordinary mutuals, with two important exceptions.

First, reciprocal underwriters and interinsurers may elect to take into account the income of the attorney-in-fact which is attributable to the insurance business of the reciprocal. It accomplishes this by not deducting that part of the fee paid to the attorney-in-fact which is equivalent to the attorney-in-fact's profit from the insurance operation. This election may be made, however, only if the attorney-in-fact is a corporation which keeps its records on the same basis as the reciprocal and certain other requirements are met.

An election by a reciprocal is never to reduce income taxes of the attorney-in-fact. The attorney-in-fact will continue to determine its tax just as it does under present law except that it must identify income and expense items attributable to the insurance business of the reciprocal.

An electing reciprocal will compute its tax liability on the combined income, under your committee's amendments, by applying the formula of this bill to the combined underwriting income. As an offset to the increased tax due to the inclusion of the income of the attorney-in-fact, the reciprocal may take tax credit for the tax paid by the attorney-in-fact with respect to its income from insurance operations. (Under certain circumstances this may result in a refund to the reciprocal.)

If the combined underwriting account of the reciprocal and its attorney-in-fact shows a loss the ordinary rules of the bill for charging it are to apply. Thus, the loss would be charged first to investment income if it is from the payment of claims, policy dividends or expenses, or to the protection against loss account of the reciprocal if it is a loss created by the special loss protection deduction.

The inclusion of the income of the attorney-in-fact in the income of the reciprocal permits the reciprocal to set aside a larger portion of income in the protection against loss account than it otherwise could, since 25 percent of the combined income is thus set aside. Your committee believes this amendment is necessary to give policyholders of a reciprocal company much the same protection as that given to the policyholders of an ordinary mutual company. However, a reciprocal, under your committee's amendment, must after 5 years restore to income all of the amount added to the protection against loss account which was attributable to the income of the attorney-in-fact which has not in the interval been absorbed by losses.

The second special feature of the bill relating to reciprocal underwriters or interinsurers permits them to deduct savings credited to individual subscribers' accounts (in the same manner as policyholder dividends paid in cash) if the company is obligated to pay those amounts promptly to the subscriber if he terminates his contract. This is provided because the "pure," or "classical," reciprocal or interinsurer typically credits the account of each policyholder with savings attributable to his contract and because the policyholder has a legal right to receive the amount so credited if he withdraws from the exchange. Because amounts credited to the account of an individual subscriber represent reductions to him in the cost of insurance, the bill provides that for income tax purposes the subscriber must reflect this reduction when the credit is made.

This deduction for credited savings, as stated above, is to be available only in case of so-called "pure" or "classical" reciprocals or interinsurers where the credits, as a matter of actual practice, are paid to policyholder subscribers who terminate their contracts. An ordinary reciprocal which may nominally meet the requirement of the statute would not be entitled to this deduction where savings credited to subscribers are not in fact returned to them when they terminate their policies.

6. Factory mutual insurance companies.—The bill amends the law with respect to factory mutual insurance companies in two important respects. First, commencing in 1963, these companies will be treated for tax purposes as if they were stock companies. This means that they will report their underwriting income in full in the year earned, and their underwriting losses after 1962 will be deductible in full.

Secondly, the method of computing premium income of factory mutuals is modified to conform more closely to the actual operation of these companies. This is accomplished by permitting them to determine their premium income on the basis of their schedule of absorbed premium deposits. The amount thus determined is then to be increased under the bill by 2 percent of absorbed premiums for income tax purposes. For example, a factory mutual might require a premium deposit of $1,000 and its experience indicates it will absorb 12 percent of the premium deposit each year during the term of the policy. Under existing law, in the case of a 3-year policy, the factory mutual would realize earned premiums of $333.33 each year (one-third of the premium deposit) and would deduct returns to policyholders as if they were dividends. Actually, however, the factory mutual absorbs only 12 percent of the premium deposit, or $120 each year. Under the bill, this factory mutual will report for income tax purposes $122.40 ($120 plus 2 percent of $120). This bill also provides for an adjustment in the unearned premium account of the factory mutual for returns of unabsorbed premium deposits to policyholders upon termination of their policies. This return of unabsorbed premium deposit is viewed as analogous to a dividend or a payment similar to a dividend.

7. *Mutual marine insurance companies.*—Mutual marine insurance companies have been taxed as stock insurance companies for many years and your committee's bill continues this treatment for them. However, a question has arisen as to whether such a company, if previously taxed as a mutual marine company, should continue to be so taxed. Your committee believes that under existing law a taxpayer which has always filed its returns as a mutual marine company should be treated as such for all years without regard to whether marine premiums still constitute its predominant source of premium income. In order to clarify the law, and foreclose the possibility that a mutual company may be taxed under different sections in different years, in lieu of a definition, your committee's bill provides that any mutual marine insurance company which was taxed as a stock company for a period of at least 5 years may elect to continue to be so taxed. The phrase "whether or not marine insurance is its predominant source of premium income" is intended to make clear that a company which has been taxed as a mutual marine company, and which has always filed its returns as a mutual marine company, may be treated as a stock company for all such years, even though marine insurance is no longer its predominant source of premium income.

8. *Special transitional loss deduction.*—Your committee has added a new provision to the House bill under which mutual insurance companies which have experienced a long and unusual period of underwriting losses will be permitted to take those losses into account in determining their taxable income. Companies qualifying for this treatment are those who have incurred underwriting losses in at least 5 out of the 6 taxable years preceding 1963. Companies which qualify for this treatment may deduct the excess of their underwriting losses over underwriting gains for the 6-year period in the years 1963 through 1967. This 5-year period is the same as the 5-year carry-forward provision of present law which applies in the case of net operating losses. Your committee felt that this treatment is justified because companies with long unfortunate loss experience must of necessity retain additional amounts of underwriting income to rebuild their reserves to a safe level. In the absence of this provision, these companies would be subjected to tax on an unusually high proportion of underwriting income.

9. *Exemption for small mutual insurance companies.*—Your committee also has added a new provision to the House bill which increases the limitation on tax exemption for small mutual insurance companies from $75,000 to $150,000. Increasing this limitation will provide complete tax exemption for approximately 160 additional small mutual insurance companies, many of which are of the pure assessment type.

10. *Mutual flood insurance companies.*—Another provision added to the House bill by your committee requires mutual flood insurance companies to be taxed under the stock formula in the same manner as mutual fire insurance companies issuing policies for which the premium deposits are the same regardless of the length of the term for which the policies are issued if the unabsorbed portion of the premium is returned to the insured upon termination of the policy. This same rule (as explained in par. 6, above) applies also to factory mutual insurance companies.

11. *Effective dates.*—The amendments made by this section are to apply with respect to taxable years beginning after December 31, 1962, except that the amendment relating to mutual marine insurance companies is to apply to taxable years beginning after December 31, 1961.

IX. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

(Sec. 9 of the bill and secs. 902 and 78 of code)

A. Reasons for provision

The Secretary of the Treasury in his appearance before your committee stated that foreign income received by domestic corporations in the form of dividends—

> 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.

He termed this an unjustified tax advantage and recommended that, as provided in the House bill, it be eliminated.

The problem arises when the foreign tax rate is below the U.S. tax rate and results from the fact that the amount paid in foreign taxes not only is allowed in part as a credit in computing the U.S. tax of the corporation receiving the dividend, but also is in effect allowed as a deduction (since the dividends can only be paid out of income remaining after payment of the foreign tax).

The problem can be illustrated by assuming that a foreign government imposes a 30-percent tax with respect to $1,000 of income of a corporation. This would leave $700 of the $1,000 out of which a dividend could be paid to a U.S. parent corporation. If the applicable U.S. tax rate is 52 percent, the American tax on this $700 before the allowance of any foreign tax credit would be $364. On the other hand, if the $1,000 of income had been earned by a branch of the U.S. corporation, the entire $1,000 would be subject to U.S. tax before allowance of any foreign tax credit. Thus, in this case the tentative U.S. tax would be $520, or $156 more than in the case of the foreign subsidiary.

In the case of the foreign subsidiary, the foreign tax allowed as a credit is limited to the same proportion of the tax which the income included in the American tax base is of the total income.[1] Thus, the allowable credit in the case of the foreign subsidiary is limited to seven-tenths of the $300 or $210. As a result the final U.S. tax on the dividend is $154 ($364 minus $210). This U.S. tax of $154, plus the foreign tax of $300, results in a total tax of $454, which is $66 less than the full $520 tax which would be paid by a domestic corporation operating in this country, or operating abroad through a branch.[2] This example is summarized in table 4 below.

[1] This is the result of the decision in *American Chicle Company* v. *U.S.*, 316 U.S. 450 (1942).

[2] As indicated above, the U.S. tax before credit in the case of the branch would be $520. After allowing the $300 foreign tax credit in this case, the final U.S. tax would be $220 which, with the $300 of foreign tax, means a total tax of $520.

TABLE 4.—*The computation of corporate taxes on foreign income*

	Existing law	Proposed law
	Dollars	*Dollars*
Profits of subsidiary	100.0	100
Foreign tax (assumed rate: 30 percent)	30.0	30
Dividend to U.S. parent	70.0	70
"Gross-up" of dividend		30
Tentative U.S. tax at 52 percent	36.4	52
Credit for foreign tax paid by subsidiary	21.0	30
Net U.S. tax	15.4	22
Combined foreign and U.S. tax	45.4	52

The size of this tax differential which exists in the case of dividends from foreign subsidiaries at the present time varies with the size of the foreign tax rate. As shown in table 5, the tax differential disappears either when the foreign tax rate equals or exceeds the U.S. tax or when there is no foreign tax imposed at all. The maximum tax differential, given a 52-percent U.S. tax rate, occurs when the foreign tax rate is half that, or 26 percent. The differential at this point is 6.7 percentage points.[3] Where dividends are received by a domestic corporation from its foreign subsidiary, which in turn has received its income from another foreign subsidiary, the maximum tax differential (given the 52-percent U.S. tax rate) amounts to 11.93 percentage points.

TABLE 5.—*Rate differential enjoyed with respect to dividends from foreign subsidiaries with various selected foreign income tax rates and present 52-percent U.S. rate*

Income before tax	Foreign tax	Income available for dividend	U.S. tax before credit	Credit against U.S. tax	U.S. tax	Total tax	Rate differential enjoyed by foreign subsidiary
							Percentage points
$100	0	$100	$52.00	0	$52.00	$52.00	0
$100	$5	95	49.40	$4.75	44.65	49.65	2.35
$100	10	90	46.80	9.00	37.80	47.80	4.20
$100	20	80	41.60	16.00	25.60	45.60	6.40
$100	26	74	38.48	19.24	19.24	45.24	6.76
$100	30	70	36.40	21.00	15.40	45.40	6.60
$100	40	60	31.20	24.00	7.20	47.20	4.80
$100	50	50	26.00	25.00	1.00	51.00	1.00
$100	52	48	24.96	24.96	0	52.00	0

Two relatively minor technical corrections recommended by the administration are also included in the House bill. One of these involves the repeal of a subsection (sec. 902(d)) of one of the foreign tax credit provisions, which makes the foreign tax credit available in limited cases with respect to royalty income received from a foreign subsidiary. This royalty income is entitled to this foreign tax credit only where the domestic corporation owns all of the stock of the subsidiary. The provision granting this treatment in the case of royalty income was adopted in 1954 in order to grant relief in a case where, because of currency exchange restrictions, a corporation was prohibited from distributing its earnings. The retention of this provision would have the effect of allowing a foreign tax credit before actual dividend distributions have been made.

[3] The tax differential represents the difference between the U.S. and foreign tax rates, multiplied by the income omitted from the U.S. tax base.

Second, the House bill also follows a recommendation of the administration relating to the interrelationship of the foreign tax credit and the intercorporate dividends received deduction. The problem arises here where a foreign corporation derives 50 percent or more of its income from sources within the United States. In such a case a domestic corporation receiving dividends from it is eligible for the 85-percent intercorporate dividends received deduction with respect to the proportion of the income determined to be from sources within the United States. However, all of the remaining income is treated as income from sources without the United States for which a foreign tax credit is available, including the 15-percent amount remaining after the allowance of the intercorporate dividends received deduction which, for that purpose, was treated as income from sources within the United States. The House bill provides that this 15 percent of domestic source income, remaining after the dividend received deduction is allowed, retains its domestic source character rather than being reclassified as foreign source income for purposes of the foreign tax credit.

B. Comparison of committee amendments with House provision

Your committee agrees with the House that, as a result of including only dividend income in the tax base and at the same time allowing a foreign tax credit, the full U.S. tax is not paid on most dividend income received by domestic corporations from foreign corporations. Your committee agrees with the House that in the case of dividend income received from developed countries, there is no reason for this tax differential. Therefore, except in the case of income received from "less developed country corporations" it has provided, as does the House bill, that where a taxpayer elects the foreign tax credit he must increase, or "gross-up," his U.S. tax base by including in it the amount of foreign income paid in taxes to the extent related to the dividend received. Thus, in the example cited in part A, above, the tentative U.S. tax would be computed on the basis of $1,000, instead of $700, and then the full $300 of foreign tax would be allowed as a foreign tax credit in the same way as in the case of branches of U.S. corporations.

In the case of corporations deriving most of their income from less developed countries, however, your committee concluded that it would be inappropriate at this time to raise the effective rate of combined American-foreign tax since this would discourage new investments in such countries. Your committee believes that to discourage such investments at this time would be contrary to our national policy.

The term "less developed country corporation" for purposes of this provision has the same definition as in section 12, but here also is defined to include certain holding companies not included in the definition in section 12. In general terms, a less developed country corporation is a corporation organized under the laws of a less developed country, which is engaged in the active conduct of a trade or business, which derives 80 percent of its gross income from sources within less developed countries, and which has 80 percent in value of its assets invested in a trade or business in a less developed country and certain other assets consistent with the carrying on of this trade or business. Certain shipping and aircraft corporations also qualify. A third category of corporations which for purposes of this one provision also qualify as less developed country corporations consist of foreign holding companies (wherever incorporated) which own 10 percent or more of the stock in less developed country corporations and which receive 80 percent or more of their gross income from sources within less developed countries and have 80 percent or more in value of their assets invested in the same manner as other less developed country corporations.

Your committee has accepted the other two amendments made by the House bill without change; namely, that relating to the deletion of the provision treating royalty income in certain cases as dividends from a foreign subsidiary and that treating all income eligible for the domestic intercorporate dividends received deduction as domestic rather than foreign income for purposes of the foreign tax credit.

C. General explanation of provision

1. Provision for "gross-up" except in the case of less developed country corporations.—Your committee's amendments provide that, except in the case of less developed country corporations, if a domestic corporation elects to take a foreign tax credit (rather than a deduction for foreign taxes), it must include in its gross income an amount equal to the taxes of its subsidiary (or an amount equal to the taxes of its subsidiary's subsidiary) which it is considered, or deemed, to have paid, for purposes of the foreign tax credit provision, with respect to the dividend income received (or treated as having been received under sec. 12 below). Thus, for a domestic corporation to claim a foreign tax credit for foreign taxes paid by its subsidiary which is not a less developed country corporation, or a subsidiary of that subsidiary, it must "gross-up" its dividend income received by the amount of the foreign income, etc., taxes attributable to it.

Your committee's bill also rewrites the rules of present law which determine the portion of the foreign taxes which are treated as being attributable to dividend income received from a 10-percent-owned subsidiary which is not a less developed country corporation and from one which is a less developed country corporation.

In the case of a subsidiary which is *not* a less developed country corporation, all of the foreign income, etc., taxes can be allowed as a credit since in this case the entire earnings before tax are taken into account by the domestic corporation. In the case of dividends received from *less developed country corporations* only the portion of the foreign income, etc., taxes attributable to the accumulated earnings and profits after foreign taxes can be allowed as a credit since only these earnings and profits are taken into income by the domestic corporation. This continues the principles laid down by the Supreme Court in *American Chicle Co.* v. *United States*, 316 U.S. 450 (1942).

As under present law, if a 10-percent-owned foreign corporation owns 50 percent or more of another foreign corporation, a foreign tax credit is allowed with respect to foreign taxes paid by the second tier foreign corporation to the extent the dividends received by the domestic corporation are attributable to those paid by the second tier corporation. Under your committee's amendments dividends received by a domestic corporation are either "grossed up" or not "grossed up" in such cases on the basis of the status of the first tier foreign corporation. Thus, if the first tier foreign corporation is a less developed country corporation, the status of the second tier foreign corporation in this respect is immaterial (except insofar as the distributions by it to the first tier corporation aid or hinder the first tier foreign corporation in qualifying as a less developed country corporation). Where there is to be no "gross-up" at the second tier level, the foreign taxes allocated to the dividend are allocated under rules consistent with the principles set forth in the court decision *American Chicle Co.* v. *United States*.

For purposes of this provision, three different categories of corporations are treated as "less developed country corporations." The first two of these are the same as the definition of a less developed country corporation for purposes of section 12 below. The third category, which essentially is a holding company for one or more less developed country corporations is an additional category that applies only for purposes of this one provision.

A less developed country corporation in the first category is a corporation organized under the laws of a less developed country, which is engaged in the active conduct of a trade or business, derives 80 percent or more of its gross income from sources within less developed countries, and has 80 percent or more of its assets (in terms of value) invested in a manner consistent with carrying on a trade or business in a less developed country. Thus, this 80 percent of its assets must consist of—

(1) Property used by it in its trade or business in less developed countries;

(2) Money and bank accounts;

(3) Stock and obligations (having a maturity of 5 years or more at time of acquisition) of less developed country corporations;

(4) An obligation of a less developed country;

(5) Investments required because of restrictions imposed by less developed countries; and

(6) Certain U.S. property, such as U.S. Government bonds, money, property purchased in the United States for export, etc., which, although having a U.S. situs, for purposes of section 12 below are excluded from the definition of "U.S. property."

The second category of corporation classified as a "less developed country corporation" consists of certain shipping or aircraft companies. These corporations must be foreign corporations 80 percent or more of the gross income of which arises from—

(1) The use (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country;

(2) From the performance of services directly related to these aircraft or vessels;

(3) From the sale or exchange of such vessels or aircraft;

(4) Dividends and interest received from foreign corporations which are themselves less developed country corporations under the definition contained in this category and in which the corporation in question has at least a 10-percent stock interest; and

(5) Gain from the sale or exchange of stock or obligations of foreign corporations which are less developed country corporations.

In addition, to qualify as less developed country corporations, these shipping or aircraft companies must have 80 percent or more of their assets either used for the production of the income described above, or consisting of property which although having a situs in the United States is not considered as "U.S. property" under the exceptions set forth in section 12.

The third category of corporations qualifies as less developed country corporations only for purposes of this "gross-up" provision. These corporations are foreign corporations (which may or may not be organized under the laws of a less developed country) which have at least a 10-percent stock interest in another foreign corporation which is a less developed country corporation within the meaning of the first category specified above. In addition, the foreign corporation must derive 80 percent of its gross income from sources within less developed countries and 80 percent in value of its assets must be of the type specified in category No. 1, above.

2. Dividends from U.S. sources.—The bill amends the rules used in determining whether income is from within or without the United States in the case of a foreign corporation which has received 50 percent or more of its gross income for the 3 prior years from sources within the United States. In such a case, the 85-percent intercorporate dividends received deduction is available with respect to the proportion of its income which its income derived from sources within the United States bears to its income from all sources. However, under present law all of such a corporation's income, to the extent it exceeds the 85-percent deduction allowed for intercorporate dividends received, is treated (for purposes of the foreign tax credit) as income from sources without the United States. Thus, the 15 percent for which no intercorporate dividends received deduction is allowed, although for purposes of the prior computation treated as from sources within the United States, is for this purpose treated as foreign source income. The bill corrects this technical deficiency by providing that the amount treated as foreign source income in such a case is only the remaining income in excess of this 15 percent.

3. Royalty income eligible for foreign tax credit.—The bill eliminates the provision of present law (sec. 902(d)) which treats as a distribution (and, therefore, eligible for the foreign tax credit) royalty payments received by a domestic corporation from a 100-percent owned subsidiary engaged in manufacturing, production, or mining.

4. Effective date.—The provisions referred to above are applicable to *all* dividends received by a domestic corporation after December 31, 1964. They also are to apply to *certain* dividends received by the domestic corporation in the period before January 1, 1965, but only in its taxable years beginning after December 31, 1962. (For a calendar year corporation this latter category includes certain dividends received in the calendar years 1963 and 1964.) In the case of dividends received in these years the "gross-up" and other changes made by this provision are to apply only to the extent that the dividends are treated for tax purposes as made out of the accumulated profits of the foreign corporation for taxable years beginning after December 31, 1962. Dividends received by a foreign corporation from its subsidiary before January 1, 1965, which are paid out of the subsidiary's profits from before 1963 are to be treated as paid out of the first foreign corporation's profits from before 1963 if it in turn pays the dividends to the domestic corporation before January 1, 1965.

X. SEPARATE LIMITATIONS ON FOREIGN TAX CREDIT WITH RESPECT TO CERTAIN INTEREST INCOME

(Sec. 10 of the bill and sec. 904(f) of the code)

A. Reasons for provision

The Secretary of the Treasury in his appearance before your committee pointed out that last summer Canada revised its tax laws to provide a 57½-percent effective rate of Canadian tax on income going to U.S. corporations operating in branch or subsidiary form in Canada. He stated that this Canadian tax, in excess of the U.S. 52-percent rate, has highlighted a procedure of using the foreign tax credit as an artificial enducement to the outflow of short-term U.S. capital. The Secretary stated that this was harmful to our monetary stability and balance-of-payments position.

Under existing law, a U.S. corporation deriving income from business abroad through a branch or a subsidiary can be expected to have an unused foreign tax credit if the foreign tax rate exceeds the U.S. rate. However, if additional foreign source income, such as interest, can be earned which is subject to a foreign tax rate which is lower than the U.S. rate, then the two types of income can be combined under the existing foreign tax credit rules. In this way the U.S. tax on the investment funds, which the foreign country taxes at a rate at much less than the U.S. rate, can be reduced or completely eliminated by being offset against the excess credit from the tax on the business income. For example, if U.S.-owned business operations are taxed in Canada at a 57½-percent effective rate, this leaves an excess credit of 5½ percentage points over and above the tax which can be credited against the U.S. 52-percent tax. The Canadian rate of tax on interest income, however, is only 15 percent. As a result, the U.S. company involved may transfer to Canada short-term funds, such as bank deposits, which would ordinarily be held in the United States. The excess credit from the business income in this case eliminates the U.S. tax on all, or a part, of the interest income, with the result that the interest income in effect is taxed at only a 15-percent Canadian rate as compared with the 52-percent U.S. rate which would apply if the funds were held here.

The Secretary of the Treasury stated that the existence of this situation has served as an artificial enducement to the movement of U.S. capital abroad. He recommended that the foreign tax credit for certain investment income be computed apart from the foreign tax credit for all other foreign income, in order to end the use of this device. Your committee is in accord with the Secretary on this provision, except that it has limited the separate computation to interest income which is unrelated to the foreign trade or business.

B. Comparison of committee amendments with House provision

The House bill does not contain this provision.

C. General explanation of provision

Under present law the foreign tax credit which may be taken with respect to any foreign income is limited to the same proportion of the United States tax (computed without the credit) which the taxpayer's taxable income from sources within a foreign country, or all foreign countries, is of his entire taxable income. This limitation, at the option of the taxpayer, can be applied either separately, i.e., on a per country basis, with respect to the income from each foreign country, or on an aggregate, or overall, basis with respect to all income received from all foreign countries.

Your committee's amendments provide that this limitation on the foreign tax credit is to be applied separately with respect to a certain type of interest income. It also provides that the limitation always is to be applied on a "per country" basis with respect to the specified interest income. Thus, if the taxpayer has been using the overall limitation, this limitation will continue to apply with respect to all income, other than the special interest income, from all foreign countries. However, the limitation will be applied separately for the special interest income derived from each foreign country. If the taxpayer is using the per country limitation, he will be permitted to continue on this basis but will have to apply the limitation separately with respect to the special interest income and other income derived from each country.

The interest income for which the separate computation of the limitation on foreign tax credit is to be made is all interest income, other than interest—

(1) Derived from any transaction which is directly related to the active conduct of a trade or business in a foreign country or possession (such as interest income on accounts receivable by a foreign business arising from its ordinary business transactions);

(2) Income derived from the conduct of a banking, financing or similar business; or

(3) Income received from a corporation in which the taxpayer has at least a 10-percent voting stock interest.

The first exception above includes interest income derived from obligations received where it was necessary to dispose of an active trade or business carried on in a foreign country or U.S. possession or of securities in a foreign subsidiary corporation in which the taxpayer has at least a 10 percent interest.

The bill also provides transitional rules for applying carrybacks of unused credits from years before the separate computation for interest was required to years after such separate computation is required, and also for carryovers from years before such separate computation was required to years after such computation was required. These rules are intended to be applied both where the taxpayer is on a "per country basis" and where he is on an "overall basis." The bill provides that where amounts are carried back to years before this separate computation was required, the new provision can be ignored for the purpose of these carrybacks. Where all of these carrybacks are not used in these prior years, however, and therefore are carried forward to future years, then separate carryforwards are to be provided, determined upon the ratios of the special interest income and other income to total income in the year in which the unused credit arose. Where an unused foreign tax credit is carried forward from a year in which no separate computation was required to a year in which such a separate computation is required, the carryforwards are to be divided between the special interest income and other income in accordance with the ratio of each to the total income in the current year.

This provision is to apply with respect to taxable years beginning after the date of enactment of this bill but only with respect to interest resulting from transactions consummated after April 2, 1962. This date was selected because it represents the date on which the Secretary of the Treasury appeared before your committee and requested action on this provision.

XI. EARNED INCOME FROM SOURCES OUTSIDE THE UNITED STATES

(Sec. 11 of the bill and secs. 911 and 72(f) of the code)

A. Reasons for provision

Under present law an individual citizen of the United States who is a bona fide resident of a foreign country may exclude from his U.S. tax base his entire earned income from sources outside of the United States. In addition, an individual who goes abroad, but does not establish a foreign residence, may exclude from his U.S. tax base his earned income up to $20,000 a year if he remains abroad for a period of 17 out of 18 consecutive months.

The President recommended that in the case of citizens living abroad in developed countries there be no exclusion for income earned abroad. In the case of less developed countries he would keep the present exclusion of up to $20,000 a year in the case of those who are abroad 17 out of 18 months, and also provide the same $20,000 ceiling with respect to those who are bona fide residents of a foreign country.

The House bill provides a ceiling on the exclusion for income earned abroad. However, it does not attempt to distinguish between U.S. citizens residing or present in developed and those in less developed countries. As a result, it retained the 17-out-of-18-month provision of present law without any major change in the presently applicable $20,000 ceiling. In the case of a bona fide resident of a foreign country the House bill also provides the same $20,000 limitation for the first 3 years the individual resides abroad. However, if the individual resides abroad for an uninterrupted period of more than 3 consecutive years a higher ceiling of $35,000 is provided. Thus, during the first 3 years an individual is abroad the exclusion will be the same, whether the individual is a bona fide resident of the foreign country or merely there for 17 out of 18 months. However, in recognition of the fact that those who are abroad for longer periods of time are more dependent on the foreign economy, and less upon the U.S. economy, the higher ceiling of $35,000 is provided in the case of these longer stays.

A second recommendation of the administration in this area relates to pensions and deferred compensation paid to U.S. citizens, after they have ceased to earn income abroad, but with respect to periods of time during which they did earn income abroad.

In the case of pensions generally, an employee receives back over his period of life expectancy (or in some cases in the first 3 years) the amount he paid toward his pension. The remainder of the pension payments he receives, consisting of contributions by the employer and interest on the funds while they were accumulating, is taxable to him as the pension or annuity payments are received.

In the case of a citizen who has been a bona fide resident of a foreign country, or been in a foreign country for a period of 17 out of 18 months or more, the employer's contributions toward the pension fund with respect to him, during the period the employee was abroad are treated in the same manner as his own contributions and, therefore, are not taxable to him when he draws his pension or annuity upon retirement. This is true even though he may be living in the United States next to someone who has worked for the same employer in the United States and is fully taxable on contributions made by the same employer.

To remove this discrimination the House bill provides that contributions by an employer will, to the extent that they relate to future employment, be fully taxable to the employee when he receives the pension payments reflecting these contributions. Thus, for the future even though employer contributions are attributable to a period when the employee was earning income abroad after 1962, these contributions by the employer will be taxable to him in the same manner as in the case of a domestic worker also receiving a pension. This will be true whether the employee is living in the United States, or abroad, at the time of the receipt of the pension payment.

Also, under the House bill where an individual receives deferred compensation after the end of the taxable year following the year in which the services were performed this compensation is not to be eligible for the exclusion for income earned abroad. The purpose of the exclusion is to provide a special inducement for American citizens or residents to hold employment abroad. However, there does not appear to be any reason to provide this special inducement long after the period in which the employment occurred. Moreover, this will treat deferred compensation under the exclusion the same as qualified pensions.

B. Comparison of committee amendments with House provision

Your committee has retained the House provision with respect to the limitations on the exclusion of income earned abroad with but two relatively minor modifications. Your committee also has accepted the House bill's treatment of contributions to a pension plan and of deferred compensation arrangements without change.

One of the changes made by your committee in the exclusion for income earned abroad is to deny any exclusion to an individual as a "bona fide resident of a foreign country" if the individual: (1) has earned income from sources within that foreign country; (2) has filed a statement with the authorities of that country that he is not a resident of it; and (3) has been held not subject to income tax as a resident of that country. This is intended to prevent an individual from avoiding income tax in the United States and the foreign country by taking inconsistent positions with respect to residence in the two countries.

The second change also relates to the exclusion for income earned abroad by bona fide residents of a foreign country. The attention of your committee was called to the fact that some residents of a foreign country have for a long time received certain fringe benefits, which in the past there was no need to value because of the unlimited exclusion. The type of fringe benefits referred to are noncash compensation, such as provision for a home or a car. It has been suggested that it may take some time to properly value these benefits. In addition, it has been suggested that the inclusion of such fringe benefits in the U.S. tax base will present an adjustment problem for these individuals. To give such individuals time to properly value these benefits and adjust to their new tax status, your committee's amendments provide that these fringe benefits will be entirely excluded from taxable income for a taxable year ending in 1963, will be excluded to the extent of two-thirds for years ending in 1964, and will be excluded to the extent of one-third for years ending in 1965. Thereafter, these amounts will be taxable to the extent that they, together with any cash (or other) income earned by the individual from foreign sources exceed the $20,000 or $35,000 limitation, whichever is applicable.

C. General explanation of provision

1. Ceiling on earned income exclusion.—The bill places a ceiling on the amount which may be excluded from income in the case of a citizen of the United States who is a bona fide resident of a foreign country or countries. The bill provides that the total amount which may be excluded with respect to the first 3 years an individual is abroad as a bona fide resident is $20,000 a year. This is the same ceiling which presently is applicable in the case of citizens or residents of the United States who are abroad for a period of 17 out of 18 months. However, in the case of the U.S. citizen who has been a bona fide resident of a foreign country or countries for more than 3 years, the total amount which may be excluded under the bill in this case (except for the fringe benefits referred to below) is to be $35,000 per year instead of $20,000. This higher ceiling is to apply with respect to any portion of a taxable year remaining after the individual has been a bona fide resident of a foreign country or countries for the uninter-tupted 3-year period. Where at the time of the passage of this legislation the individual already has been a bona fide resident for 3 years or more, this higher ceiling will, of course, become applicable immediately.

In applying either the $20,000 or $35,000 ceiling under community property laws the total community income excludable may not exceed the amount which would be excludable if this income were not community income. Thus, one $20,000 or $35,000 ceiling will apply with respect to the husband's earnings abroad even though under community property law, half of this income is the income of the wife. However, if both husband and wife are abroad and earn income, separate ceilings will be applied with respect to the earnings attributable to the services of each.

The $20,000 or $35,000 limitation applicable to a bona fide resident of a foreign country is not to apply to certain fringe benefits during a transitional period. The fringe benefits referred to are the right to use property or facilities, such as a home or a car. No part of such compensation received from sources without the United States (unless paid by the U.S. Government) is to be taken into account, and only other earned income in excess of $20,000 or $35,000 will be taxed for taxable years ending in 1963. For taxable years ending in 1964, one-third of the value of this type compensation is to be taken into account and for taxable years ending in 1965, two-thirds of the value is to be taken into account. Thereafter, such compensation will be fully taxable, subject to the $20,000 or $35,000 limitation, in the same manner as any other compensation.

The bona fide resident rule has also been modified to provide that an individual is not to be treated as a bona fide resident of a foreign country if he has earned income in the foreign country, has made a statement to the authorities of that country that he is not a resident of it, and has been held not subject as a resident of that country to its income tax. This does not prevent an individual from qualifying under the exclusion for presence in a foreign country or countries for 17 out of 18 months. It also does not deny an individual an exclusion as a bona fide resident if, under wholly consistent positions with respect to residence in the United States and a foreign country, he is held by both countries to be a nonresident.

2. Deferred compensation.—Under present law the bona fide resident rule and the 17- out of 18-month rule work somewhat differently in determining the year to which the exclusion relates. The bona fide resident rule at present provides an exclusion without limit for amounts received from sources without the United States which are "attributable" to the period when the U.S. citizen was a bona fide resident of a foreign country. This means that deferred compensation attributable to a period of foreign service is excludable even though received many years after the period of service.

The 17- out of 18-month rule, however, because of the $20,000 ceiling, has been interpreted as limiting the exclusion which an individual may receive to the proportion of the taxable year, during which the payment was *received*, in which the individual was abroad. Thus, where the individual receives deferred compensation after he has been back in the United States for an entire taxable year, no exclusion is available. Moreover, in this latter case, hardship situations have occurred where an individual, who has returned to the United States early in a year, has received payments attributable to service in the prior year, but because the individual is in the United States most, or all, of the year little, or no, exclusion is available with respect to this income.

The bill eliminates the problems referred to above by attributing the income, for purposes of applying the dollar limitation on the exclusion, to the year in which the service is performed. This means that the exclusion, merely because the individual has returned to the United States before receiving the payment, will not be denied. However, most deferred compensation is made ineligible for the exclusion by providing that no exclusion will be allowed for amounts received more than 1 year after the close of the taxable year in which the services are performed.

3. Pension income.—The provision of present law dealing with annuities (sec. 72(f)) provides that in determining what the employee or annuitant paid for an annuity contract, there is to be included contributions of the employer, if, had these contributions been paid to the employee in the first instance, they would not have been taxable to him. This provision generally has the effect of excluding employer contributions to a pension plan from tax (in the year the pension payment is received) where the employee is abroad and qualifies for the exclusion.

The bill nullifies this section by providing that the exclusion for income earned abroad is not to be available in the case of amounts contributed after December 31, 1962, and subsequently received as pensions or annuities or amounts which otherwise would be included in gross income in the case of beneficiaries of tax-exempt trusts (sec. 402(b)), beneficiaries under nonqualified annuities (sec. 403(c)), or beneficiaries under certain forfeitable contracts purchased by exempt organizations (sec. 403(d)).

The bill also makes it clear that the tax-free status of employer contributions will be continued in the case of contributions made after December 31, 1962, to the extent that they provide pension or annuity credits where these credits are attributable to services performed on or before that date if the pension or annuity plan provisions were in existence on March 12, 1962.

4. Effective date.—The changes made by this provision (except for the fringe benefits exclusion) are to apply to amounts received after December 31, 1962, but only to the extent that these amounts are attributable to services performed after that date or services performed on or before that date, where on March 12, 1962, there did not exist a right to receive these amounts.

XII. CONTROLLED FOREIGN CORPORATIONS

(Sec. 12 of bill and secs. 951–972 of code)

A. Reasons for provision

Under present law foreign corporations, even though they may be American controlled, are not subject to U.S. tax laws on foreign source income. As a result no U.S. tax is imposed with respect to the foreign source earnings of these corporations where they are controlled by Americans until dividends paid by the foreign corporations are received by their American parent corporations or their other American shareholders. The tax at that time is imposed on the American shareholder with respect to the dividend income received, and if this shareholder is a corporation it is eligible for a foreign tax credit with respect to the taxes paid by the foreign subsidiary. In the case of foreign subsidiaries, therefore, this means that foreign income taxes are paid currently, to the extent of the applicable foreign income tax, and not until distributions are made will an additional U.S. tax be imposed, to the extent the U.S. rate is above that applicable in the foreign country. This latter tax effect has been referred to as "tax deferral."

The President in his tax message last year questioned the desirability of providing tax deferral with respect to earnings of U.S.-controlled companies except in the case of investments in less developed countries. In this respect he emphasized removing tax deferral in the case of what have been called "tax havens." Thus he stated:

> The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have arranged their corporate structures—aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven—so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.

In this area the President recommended the:

> * * * elimination of the tax haven device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation. There is no valid reason to permit their remaining untaxed regardless of the country in which they are located.

The House bill did not go as far as the President recommended. It did not eliminate tax deferral generally, but instead was concerned primarily with what had been referred to as "tax haven" devices. To accomplish this result the House bill in general sought to end tax deferral for income derived by U.S. controlled foreign corporations from insurance abroad of U.S. risks; for certain foreign investment income of these corporations; for their income from foreign sales subsidiaries which are separately incorporated from their manufacturing operations; and income invested in "nonqualified property," that is, generally, earnings not needed in the same trade or business or funds indirectly brought back to the United States without full payment of U.S. tax. In most of the categories described above deferral of the tax was not denied where earnings were reinvested in a less developed country. In addition, under the House bill (sec. 6) a special rule was added which in general provided that in the case of sales between a domestic corporation and a foreign controlled corporation the income arising from the transaction was to be divided between the corporations involved on the basis of payroll assets, and sales or promotional expenses attributable to the United States or the foreign country or countries.

B. Comparison of committee amendments with House provision

Your committee has substituted a provision for the House bill sections 6 and 13 which differs in several important respects from the House bill sections. However, your committee's amendments, like the House bill, also are designed to end tax deferral on "tax haven" operations by U.S. controlled corporations.

In the area of income arising from insurance of U.S. risks, income from passive investments, and income from sales subsidiary operations, your committee's provision is much the same as the House bill. In these areas among the more significant changes are provision for inclusion of passive investment and sales subsidiary income in the tax base of U.S. shareholders only if it represents 30 instead of 20 percent of gross income, and the expansion of the taxable categories to include service income performed for related persons. Also important are the changes relating to exclusions from the tax base for reinvestments of income. Under your committee's amendments reinvestments which reduce the tax base are limited to reinvestments of dividends and interest (or gains on the sale of investments) and these income items must not only be reinvested in less developed countries but also must be derived from such countries as well. However, the qualifying reinvestments are not limited to those in a corporation in a less developed country in which the taxpayer and no more than four other Americans have an interest of more than 50 percent, as was provided by the House bill.

Your committee's amendments differ considerably from the House provision in that they are no longer concerned with the reinvestment of earnings arising from the active conduct of a trade or business, except to be sure that these earnings are not indirectly brought back to the United States in a manner which avoids the U.S. tax. Thus, there is no requirement that such earnings be reinvested in the same trade or business in which the taxpayer has been engaged in the last 5-year period or before December 31, 1962.

A second area in which your committee's amendments differ from the House provision is in the treatment of patents, copyrights, formulas, and processes, etc., developed or acquired in the United States. Under the House bill tax deferral in the case of controlled foreign corporations having such patents, copyrights, etc., was to be denied and the income either actually or constructively attributable to such items was to be taxed to the U.S. shareholders. Your committee's bill, in a separate section (sec. 16), provides for gains from any such patents, copyrights, etc., to be taxed as ordinary gain in most cases at the time of transfer of the patent or other rights from the domestic corporation to the foreign controlled subsidiary.

A third important change in your committee's amendments is the deletion of the income allocation rule provided by section 6 of the House bill.

Your committee's amendments also differ substantially from the House provision in that they provide two major relief provisions, or "escape valves," which may be used by taxpayers to make section 12 inoperative in their case. One of these is designed to make section 12 inoperative where the overall foreign and U.S. taxes paid with respect to the foreign operations is not substantially below what the U.S. taxes would be on the income. Thus, your committee's amendments provide a schedule of effective foreign tax rates and corresponding percentages of distribution which if complied with make section 12 inoperative. The second major relief provision is the export trade corporation provision. This provides, in general, that where the products sold are those produced or grown in the United States, and where the profit attributable to these operations complies with certain specified limitations, then this "export-trade income" is not to be subject to section 12 if the earnings are reinvested in an export trade business.

Your committee's amendments are described briefly below.

C. General explanation of provision

1. *The general pattern of the provisions.*—The bill provides that certain types of income of controlled foreign corporations, even though undistributed, are to be included in the income of U.S. shareholders in the year the income is earned by the foreign corporation. In these cases the shareholders are permitted to take foreign tax credits to the same extent as if actual distributions had been made. Under the bill only U.S. shareholders are taxed on the undistributed income.[1] The U.S. shareholders to be so taxed must, either actually or constructively, have at least a 10-percent interest in the voting power of all classes of voting stock of a controlled foreign corporation. A

[1] U.S. shareholders are defined in the bill as "U.S. persons" with the 10-percent stockholding. U.S. persons, in general, are U.S. citizens and residents and domestic corporations, partnerships, and estates or trusts.

foreign corporation is a "controlled foreign corporation" for this purpose only if more than 50 percent of the combined voting power of all classes of stock is owned directly or constructively by these U.S. shareholders having a 10 percent or greater stock interest.[2]

There are two categories of undistributed income which under your committee's amendments are taxed to the U.S. shareholders of controlled foreign corporations. The first of these categories is referred to as income derived from insurance or reinsurance of U.S. risks. The second category is referred to as foreign base company income. This foreign base company income can in turn be broken down into base company personal holding company income, base company sales income, and base company service income. Collectively, the income derived from insurance or reinsurance of U.S. risks and foreign base company income is referred to in the bill as "subpart F income." The amount of this which may be taxed in any year is limited to the earnings and profits of the controlled foreign corporation for the taxable year less deficits not otherwise offset since 1959.

In addition to certain types of undistributed earnings being treated as if they were distributed and taxed to the U.S. shareholders of controlled foreign corporations, the bill also provides that earnings invested in U.S. property (with certain exceptions) are to be taxed to the U.S. shareholders. In general terms, U.S. property is property located in the United States or having a situs in the United States unless used in the foreign trade or business. Earnings invested in U.S. property are treated first as arising out of subpart F income which means that to the extent that subpart F income is taxed to U.S. shareholders, the income of the corporation will not again be taxed to the U.S. shareholders because of investments in U.S. property. Similarly, actual dividend distributions are treated first as being paid out of earnings invested in U.S. property, then out of subpart F income, and only finally, if any balance remains, out of the accumulated earnings and profits of the corporation which have not already been taxed to the shareholders. Only when actual dividends are treated as paid out of this latter category do they represent taxable dividends to the shareholders.

The earnings of a corporation classified as subpart F income or as investments in U.S. property, give rise to taxable income to the U.S. shareholders only for the portion of the earnings represented by the portion of the year in which the corporation was a controlled foreign corporation. Moreover, the shareholders are taxed only on their allocable share of the earnings with the result that any holdings by foreigners or by Americans having less than a 10-percent interest are not taxed to any shareholders under this provision.

2. Income derived from insurance of U.S. risks.—Since the passage of the Life Insurance Company Income Tax Act of 1959, which for the first time in many years imposed a tax on underwriting gains of these companies, it is understood that a number of the companies involved have attempted to avoid tax on the gains by reinsuring their policies abroad. In other cases the tax has been avoided by placing the initial policy with a foreign insurance company either controlled by an American insurance company or controlled by other American businesses.

[2] The 10-percent holding may be on any day of the taxable year of the corporation. A special additional test of control provided in the case of insurance is discussed under the heading of insurance.

To meet this problem the bill provides that where a controlled foreign corporation receives premiums or other consideration for reinsurance or the issuing of insurance or annuity contracts on property in, or residents of, the United States the income attributable to this is to be taxed to the U.S. shareholders as a part of subpart F income. This provision does not apply, however, unless the controlled foreign corporation receives premiums or other consideration for reinsurance or the issuing of insurance or annuity contracts representing U.S. risks which are in excess of 5 percent of their total premiums and other consideration.

The bill also covers the type of situation where the controlled foreign corporation does not hold the policies involving U.S. risks but instead holds other policies which, by arrangement with another corporation, it has received instead of the insurance involving the U.S. risks, while the other corporation holds the policies involving the insurance on property in, or residents of, the United States.

In the case of insurance there also is an alternative definition of a controlled foreign corporation. Under the alternative if U.S. persons hold from 25 to 50 percent of the stock, any income from insurance or reinsurance on U.S. risks is included in income taxed as subpart F income where the U.S. risks represent 75 percent of the gross amount of all premiums and other considerations received with respect to risks held by the company. This alternative rule for control is designed to cover cases where the principal business is the U.S. risks but the control is decreased in order to avoid the application of this provision.

The income subject to tax in the hands of the shareholders in the case of life insurance companies is total gain from operations to the extent attributable to U.S. risks. In effect this represents all (not 50 percent) of the underwriting income as well as net investment income.

3. Foreign base company income.—The second component of the subpart F income which will be taxed to the U.S. shareholders in the case of controlled foreign corporations is foreign base company income. This consists of foreign personal holding company income, foreign base company sales income and foreign base company services income, which are discussed below under paragraph headings *a*, *b*, and *c*. Excluded from this foreign base company income is dividend and interest income from 10-percent-related persons (and gains from the sale or exchange of the underlying investments) which are attributable to certain investments in less developed countries. Also excluded is certain income from shipping. In addition, special rules apply where the foreign base company income represents less than 30 percent or more than 70 percent of the controlled foreign corporation's gross income. A further exception is provided for foreign corporations where it is established to the satisfaction of the Treasury Department that the foreign corporations are not availed of to reduce taxes. These exclusions and special rules are discussed under paragraph heading *d*. below.

a. Foreign personal holding company income.—The income referred to here is income which under other provisions of the code already is defined as "foreign personal holding company income." Generally speaking, this is income which is passive in character. It includes income from dividends, interest, most royalties, annuities, etc. Three modifications made in this definition of "foreign personal holding company income" for purposes of this provision are noted below.

Your committee, while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same countries, nevertheless sees no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated.

The section adopts the definition of "foreign personal holding company income" appearing elsewhere in the code (sec. 553) with various modifications and adjustments.

First, *all* rental income is included in foreign personal holding company income for purposes of this provision. (Under sec. 553, rent income is only included as foreign personal holding company income if it constitutes less than 50 percent of the gross income of the corporation.)

The second important modification provides that certain income otherwise defined as foreign personal holding company income is not foreign personal holding company income for purposes of this new provision when it arises in connection with certain actual business activities. Specifically, it is provided that rents and royalties received from an unrelated person and derived from the active conduct of a trade or business will not be considered foreign personal holding company income. It is also provided that dividends, interest and gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing or similar business will not be considered foreign personal holding company income. Another exception is made for dividends, interest and gains from the sale of stock or securities derived from the investments made by an insurance company of its unearned premiums or reserves necessary for the proper conduct of its insurance business.

Finally, certain exceptions are made for income received from related parties. Your committee saw no reason for taxing the U.S. shareholders on dividends received by a controlled foreign corporation from a related party where the U.S. shareholder would not have been taxed if he had owned the stock of the related party directly. For this reason, dividends and interest received from a related corporation which is organized under the laws of the same foreign country as the controlled foreign corporation and has a substantial part of its assets used in its trade or business located in that foreign country, are not included in foreign personal holding company income. Rents, royalties, and similar amounts received from a related party (whether or not incorporated in the same jurisdiction) are also excluded from foreign personal holding company income if these amounts are received for the use of property within the country in which the controlled foreign corporation is incorporated. Also excluded from the definition of foreign personal holding company income is interest received by a banking or financial business firm from a related person also engaged in the banking or financing business, if the business of each is predominantly with unrelated persons. This means that the foreign personal holding company income will not arise merely because of normal business transactions between two or more related financial institutions.

b. Foreign base company sales income.—Foreign base company sales income is income derived from the purchase and sale of personal property if the property is either purchased from a related person or sold to a related person. However, this applies only where the property purchased is manufactured, produced, grown, or extracted outside of the country where the controlled foreign corporation is organized and the property also is sold for use, consumption or use outside of that country. The provision also covers similar cases where the controlled foreign corporation does not take title to the property but acts on a fee or commission basis.

The "foreign base company sales income" referred to here means income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation. This does not, for example, include cases where any significant amount of manufacturing, major assembling, or construction activity is carried on with respect to the product by the selling corporation. On the other hand, activity such as minor assembling, packaging, repackaging or labeling will not be sufficient to exclude the profits from this definition.

The sales income with which your committee is primarily concerned is income of a selling subsidiary (whether acting as principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income. This accounts for the fact that this provision is restricted to sales of property, to a related person, or to purchases of property from a related person. Moreover, the fact that a lower rate of tax for such a company is likely to be obtained only through purchases and sales outside of the country in which it is incorporated, accounts for the fact that the provision is made inapplicable to the extent the property is manufactured, produced, grown, or extracted in the country where the corporation is organized or where it is sold for use, consumption, or disposition in that country. Mere passage of title or the place of the sale are not relevant in this connection.

Also included in foreign base company sales income are operations handled through a branch (rather than a corporate subsidiary) operating outside of the country in which the controlled foreign corporation is incorporated, if the combined effect of the tax treatment accorded the branch, by the country of incorporation of the controlled foreign corporation and the country of operation of the branch, is to treat the branch substantially the same as if it were a subsidiary corporation organized in the country in which it carries on its trade or business.

c. Foreign base company services income.—Foreign base company services income is income derived from the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or similar services, but only where they are performed for a related person and are performed outside the country in which the controlled foreign corporation is organized.

As in the case of sales income, the purpose here is to deny tax deferral where a service subsidiary is separated from manufacturing or similar activities of a related corporation and organized in another country primarily to obtain a lower rate of tax for the service income.

d. Exclusions and special rules for foreign base company income.—The three categories of income described above which are called foreign base company income are to be taxed to the U.S. shareholders of a foreign controlled corporation only if this foreign base company income represents at least 30 percent of the gross income of the corporation. On the other hand, if the foreign base company income exceeds 70 percent of gross income, the entire gross income (reduced by deductions) of the corporation is to be treated as foreign base company income and treated as if it were distributed pro rata to the U.S. shareholders. Thus, where this foreign base company income is relatively minor, the shareholders will not be taxed on any of it; where it is a major factor, they are to be taxed on the entire income of the corporation. Otherwise, only the actual foreign base company income is to be taken into account.

The bill provides that although otherwise classified as foreign base company income, certain categories of income may, nevertheless, not be taxable to the U.S. shareholders of the controlled foreign corporation. The amounts which may not be taxed to these shareholders are dividend and interest income and gains from the sale or exchange of investments, but only if this income or these gains arose from qualified investments in less developed countries and only to the extent that these amounts are reinvested in qualified investments in less developed countries. What constitutes qualified investments in these less developed countries is discussed under paragraph heading (4) below. If a reduction in foreign base company income is granted for an increase in qualified investments in a less developed country and then at a later time these investments are decreased, then to the extent of any foreign base company income previously omitted from the tax base of the U.S. shareholders, there is to be an increase in the income of the controlled foreign corporation taxable to its U.S. shareholders.

This exception for interest and dividend income (and certain gains) from less developed countries is intended to make it possible for a controlled foreign corporation, which is at least in part a holding company, to reinvest dividends and interest obtained from a subsidiary in a less developed country in another subsidiary in a less developed country, without its shareholders being taxed on this income.

Another exception from the application of the foreign base company income is provided for income derived from the use (including the hiring or leasing) of aircraft or vessels used in foreign commerce or services directly related to the use of the aircraft or vessel. This exception was provided by your committee primarily in the interests of national defense. In this regard it was believed desirable to encourage a U.S.-owned maritime fleet and U.S.-owned airlines operating abroad.

A final exception provided from the foreign base company income is for any income received by a controlled foreign corporation, if it is established to the satisfaction of the Treasury Department that with respect to this income the controlled foreign corporation has not effected a substantial reduction of income or similar taxes.

4. Less developed country corporations.—As indicated above, interest and dividend income received from 10 percent related persons (and gains on the sale of the underlying investments) may be deducted from the subpart F income which is taxable to the U.S. shareholders of a controlled foreign corporation only if the income was attributable to qualified investments in a less developed country and was reinvested in qualified investments in less developed countries.[3] Provision is

[3] The bill provides for a reduction in subpart F income to the extent of this dividend and interest income from less developed countries or the increase in investments in these countries, whichever is the lesser.

also made for an increase in the income taxable to the U.S. shareholders whenever there is a decrease in qualified investments in a less developed country, to the extent they were initially attributable to dividends or interest of the type referred to above. The concept of less developed country corporations is also used under section 9 of this bill in determining when the "gross-up" of dividend income is not to be applied. In addition, section 15 of the bill makes use of the concept of less developed country corporations, since the ordinary income treatment provided under that provision in the case of certain corporate liquidations and stock sales does not apply where the corporation involved is a less developed country corporation the stock of which was held for more than 10 years.

Qualified investments in less developed countries under this provision consist of stock of a "less developed country corporation" and obligations of such corporations which at their time of acquisition by the controlled foreign corporation had a maturity of 5 years or more. However, for either the stock or obligations to qualify the controlled foreign corporation must own 10 percent or more of the voting power of all classes of stock of the less developed country corporation. In addition, qualified investments also include obligations of a less developed country.

"Less developed country corporations" consist of two categories. First, they include foreign corporations incorporated in a less developed country, which are engaged in the active conduct of a trade or business, which derive 80 percent or more of their income from sources within less developed countries and which have 80 percent or more (in value) of their assets in property generally used in a trade or business in a less developed country or in certain other specified types of associated property. The specific assets in which this 80 percent of the assets must be invested are—

(1) Property used by it in its trade or business in less developed countries;

(2) Money and bank accounts;

(3) Stock and obligations (having a maturity of 5 years or more at time of acquisition) of less developed country corporations;

(4) An obligation of a less developed country;

(5) Investments required because of restrictions imposed by less developed countries;

(6) Certain U.S. property, such as U.S. Government bonds, money, property purchased in the United States for export, etc., which although having a U.S. situs, are excluded from the definition of "U.S. property." (For a more specific listing of the U.S. property exceptions, see par. (5) below.)

The second category of corporation classified as a less developed country corporation are certain shipping or aircraft companies. These corporations must be foreign corporations (not necessarily incorporated in a less developed country) receiving 80 percent or more of their gross income from:

(1) The use (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country;

(2) From the performance of services directly related to these aircraft or vessels;

(3) From the sale or exchange of such vessels or aircraft;

(4) Dividends and interest received from foreign corporations which are themselves less developed country corporations under the definition contained in this category and in which the corporation in question had at least a 10 percent stock interest; and

(5) Gain from the sale or exchange of stock or obligations of foreign corporations which are less developed country corporations.

In addition, for these shipping or aircraft companies to qualify as less developed country corporations they must have 80 percent or more of their assets invested in assets used for the production of the income described above and in property which although having a situs in the United States is not considered as "U.S. property" (see exceptions listed in par (5) below).

Less developed countries under the bill are defined as foreign countries (other than areas within the Sino-Soviet bloc) or possessions of the United States where the President of the United States has designated such a country or possession as economically less developed.[4] However, the following countries are in no event to be considered as less developed countries:

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

Once a country has been designated as a less developed country, the President is not to terminate that designation without giving 30 days prior notice to the Senate and House of Representatives of his intention to do so. Moreover, if at the time of acquisition, property was qualified investment in a less developed country, this property is to continue to qualify thereafter even though the country ceases to be a less developed country.

5. *Investment of earnings in U.S. property.*—In addition to the income from insurance of U.S. risks and foreign base company income, U.S. shareholders of controlled foreign corporations also are to be taxed on other earnings of the corporation to the extent of the corporation's investments in U.S. property. For this purpose U.S. property is that acquired after December 31, 1962, which is—

(1) Tangible property located in the United States;

(2) Stock of a domestic corporation;

(3) An obligation of an U.S. person; or

(4) Any right to use in the United States a patent or copyright, an invention, model, or design whether or not patented, a secret formula or process, or any other similar property right, but only if any of the foregoing is acquired or developed by the controlled foreign corporation for use in the United States.

[4] Oversea territories, departments, provinces, or possessions for this purpose may be treated as separate countries. Thus, even though the "home" country may be classified as developed, the oversea area may be considered less developed.

Certain exceptions, however, are made to the above categories with the result that the term "U.S. property" does not include—

(1) Investments in U.S. bonds, money, or bank accounts;

(2) Property purchased in the United States for export to, or for use in, foreign countries;

(3) Loans arising in connection with the sale or processing of property where the amount of the loan would be considered ordinary and necessary to carry on the trade or business of both the lending and borrowing corporation had the sale been made between unrelated persons, or in the case of processing, would have been required of the lending corporation had the transaction involving such processing occurred between unrelated persons;

(4) Aircraft, railroad rolling stock, vessels, motor vehicles, or containers used in the transportation of persons or property in foreign commerce predominantly outside the United States;

(5) Assets of an insurance company representing reserves attributable to contracts which do not involve U.S. risks; and

(6) Assets of the controlled corporation equal to the earnings and profits accumulated after December 31, 1962, and taxed as income from sources within the United States, of a foreign corporation engaged in trade or business here.

Generally, earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them. The exceptions noted above, however, are believed to be normal commercial transactions without intention to permit the funds to remain in the United States indefinitely (except in the case of the last category where full U.S. corporate tax is being paid).

6. Minimum distribution to domestic corporation.—A major relief provision under your committee's amendments is that which provides that subpart F income (income from insurance of U.S. risks plus foreign base company income) is not to be taxed to the U.S. corporate shareholders if a schedule of minimum distributions is met. The minimum distribution required varies with the effective foreign tax rate and is as follows:

If the effective foreign tax rate is (percentage)—	The required minimum distribution of earnings and profits after foreign taxes is (percentage)—
Under 10	90
10 or over but less than 20	80
20 or over but less than 30	70
30 or over but less than 40	60
40 or over but less than 42	50
42 or over but less than 44	38
44 or over but less than 46	26
46 or over but not more than 47	14
Over 47	0

The purpose of this provision is to forego any tax on the U.S. shareholders with respect to undistributed income of controlled foreign corporations in those cases where the combined foreign tax and United States (to the extent the latter is paid on the distributed income) is not substantially below the U.S. corporate tax rate. The lower the foreign tax rate is, of course, the greater the distribution must be, and the greater the proportion of the total which must be subject to U.S. tax, if the aggregate tax is not to be substantially below the U.S. corporate tax rate. Table 2 below shows the combined U.S. and foreign taxes implicit in the schedule set forth in this provision. This is shown both on the assumption that the "gross-up" provision in section 9 applies and that it does not apply.[5] The table also shows the range of combined taxes in each bracket, assuming the application of both the minimum and the maximum effective foreign tax rate is applied in each bracket. It will be noted that the combined effective tax rates range from 42.4 to 47 percent where the "gross-up" provision applies and from 37.9 to 47 percent where it does not. For the most part, however, the combined tax is around 46 percent where the "gross-up" applies and 44 percent where it does not.

TABLE 2.—*Total U.S. and foreign tax burden resulting from minimum distribution schedule applied to $100 of earnings of a controlled foreign corporation*

Assumed effective foreign tax rate	Percent distribution required by schedule	Combined U.S. and foreign tax if dividend is—	
		"Grossed up"	Not "grossed up"
9 percent	90	$47.70	$44.22
10 percent	80	43.60	40.24
19 percent	80	45.40	40.38
20 percent	70	42.40	37.92
29 percent	70	45.10	40.43
30 percent	60	43.20	39.24
39 percent	60	46.80	43.76
40 percent	50	46.00	43.60
41 percent	50	46.50	44.25
42 percent	38	45.80	44.20
43 percent	38	46.42	44.95
44 percent	26	46.08	45.16
45 percent	26	46.82	46.00
46 percent	14	46.84	46.45
47 percent	0	47.00	47.00

Taxpayers are permitted to apply the minimum distribution schedule—

(1) separately for each controlled foreign corporation,

(2) for each chain of controlled foreign corporations,

(3) for all controlled foreign corporations, or

(4) for all controlled foreign corporations other than less developed country corporations.

In addition, taxpayers for purposes of this minimum distribution schedule may treat branches as if they were wholly owned foreign subsidiaries distributing 100 percent of their earnings. For this purpose branches maintained in Puerto Rico or a possession of the United States are taken into account, if they would be controlled foreign corporations if incorporated under the laws of Puerto Rico or the possession, and the gross income of the U.S. shareholder includes income derived from sources within Puerto Rico or the possession.

A taxpayer in computing the minimum distribution may omit income from a foreign corporation if it is established to the satisfaction of the Treasury Department that its earnings were blocked because of

[5] The method of computing the combined tax can be illustrated by the case of the 10 percent foreign tax, 80 percent distribution and no "gross-up" of the dividend. The foreign tax on the $100 in this case is $10, leaving $90 after foreign tax. Of this amount 80 percent or $72 is distributed. A 52 percent U.S. tax on this is $37.44. The credit allowed for foreign taxes paid is $7.20 ($^{72}/_{100}$×$10), leaving a net U.S. tax of $30.24. This plus the $10 foreign tax gives a combined tax of $40.24.

currency or other restrictions imposed by the laws of a foreign country. The minimum distributions referred to above may be computed if the taxpayers so elect for an affiliated group of corporations (eligible to file a consolidated return) in the same manner as if they were a single U.S. corporation.

The effective foreign tax rate referred to in the minimum distribution is determined by expressing the income, war profits, or excess profits taxes paid or accrued to the foreign countries or possessions of the United States by the foreign corporation (or corporations) involved as a percent of the earnings and profits of the foreign corporation (or corporations) plus the foreign taxes themselves. The earnings and profits referred to here are to be determined according to rules substantially similar to those applicable to domestic corporations. Taxpayers, however, will, by regulations, be permitted to depart from the U.S. rules where their books are kept on a different basis and the variations in computations are not important. A distribution may be treated as being made in a year if paid within 60 days after the end of that year or in such longer period as the Treasury Department by regulations prescribes. In addition, if a U.S. shareholder in making its return applies for the minimum distribution schedule and subsequently it is found that, for reasonable cause, it has not met the minimum schedule, then subsequent distributions may be made by the controlled foreign corporation (in a manner prescribed under regulations) and be treated as if they had been made in the earlier qualifying period.

7. *Export trade corporation.*—A second major relief provision provided by the bill is the exception for "export trade corporations." The bill provides that foreign base company income (i.e., foreign personal holding company income, base company sales income and base company service income) in the case of export trade corporations is to be reduced by the amount of their foreign base company income which consists of "export trade income." Thus, the U.S. shareholders of controlled foreign corporations will not be taxed on undistributed income of these corporations (to the extent that it represents foreign base company income) if these controlled foreign corporations are export trade corporations having "export trade income." However, the exclusion for foreign base company income representing export trade income may not exceed the lesser of—

(1) 1½ times "export promotion expenses," (attributable to the otherwise excluded income) or

(2) 10 percent of gross receipts of the export trade corporation from the sale, installation, operation, maintenance or use of the property from which it derives the income which otherwise is excluded. (In the case of commissions or fees, this 10 percent is measured on the same basis on which the commissions or fees are based.)

With the limitations it is not expected that the allocation rule in present law (sec. 482) will be needed in many cases involving export trade corporations.

The export trade income which is to be deferred also is limited to the portion of this income which is invested by the export trade corporation in "export trade assets" (or, more specifically, by the portion of the increase in investments in such assets which is attributable to export trade income which constitutes foreign base company income).

Any amount of export trade income where U.S. taxation has been deferred because of such investments, will subsequently be taxed if there is a decrease in export trade assets.

This provision is intended to continue tax deferral in the case of corporations engaged in export trade who are selling abroad products produced, grown, or extracted in the United States. This is intended as an encouragement to export trade. Nevertheless, limitations are imposed to provide that the income attributed to the export trade corporation is in line with the income actually generated by such activity. This is the function of limiting the export trade income to 1½ times export promotion expenses or 10 percent of gross receipts from the property, whichever is the lesser. Also, the provision is intentionally limited to the extent to which the export trade income receiving the special treatment is used for the expansion of the export trade business, itself.

An "export trade corporation" for this purpose is defined as a controlled foreign corporation which derives 90 percent of its gross income (for the prior 3-year period) from sources without the United States and one which derives 75 percent or more of its gross income (for the same 3-year period) from export trade income. However, if 50 percent or more of the gross income of the controlled foreign corporation (for the same 3-year period) is derived from income from agricultural products grown in the United States, this 75-percent requirement is not to apply.

The "export trade income" is an element in the definition of an export trade corporation and also, to the extent included in foreign base company income, represents the maximum amount of subpart F income upon which tax deferral may be granted. Export trade income is net income from—

(1) the sale to an unrelated person (where there is less than 50-percent common control) for use, consumption, or disposition outside the United States of export property. Export property is property manufactured, produced, grown, or extracted in the United States. (In addition to the sale of export trade property, there also is included commissions, fees, etc., from the performance of services with respect to these sales or with respect to the installation or maintenance of export property);

(2) commissions, fees, and other income from commercial, industrial, or other services performed by an unrelated person outside of the United States in connection with patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, etc., acquired or developed and owned by the domestic corporation involved;

(3) commissions, fees, rentals or other income for the use of export property by an unrelated person or attributable to the use of export property in rendering technical, scientific, or engineering services to an unrelated person; and

(4) interest from certain obligations which are export trade assets.

"Export trade assets" are the type of property in which export trade income must be reinvested if its taxation is to be deferred. Export trade assets are—

(1) working capital reasonably necessary for the production of the export trade income;

(2) inventory of export property, i.e., property manufactured, produced, grown, or extracted in the United States, held for use, consumption, or disposition outside of the United States;

(3) facilities located outside of the United States for the storage, handling, transportation, packaging or servicing of export property; or

(4) evidences of indebtedness executed by unrelated persons in connection with the payment for purchases of export property or services.

As indicated previously, the export trade income (to the extent entering into foreign base company income) which may be deferred is limited to 1½ times "export promotion expenses" or 10 percent of gross receipts from the property from which the export trade arises, whichever is the lesser. "Export promotion expenses" are the following expenses paid or incurred in connection with the export trade income—

(1) a reasonable allowance for salaries or other compensation for personal services,

(2) rentals or other payments for the use of property,

(3) a reasonable allowance for the exhaustion, wear and tear of property, and

(4) any other ordinary and necessary expenses to the extent reasonably allocable to the export trade income.

No expense incurred in the United States is to be treated as an export promotion expense unless at least 90 percent of each category of expense is incurred outside the United States.

8. Other relief provisions.—In addition to the minimum distribution schedule and export trade corporation provision which may exclude from the tax base of U.S. shareholders undistributed income of controlled foreign corporations, the bill provides two other important relief measures. First, it provides that a U.S. shareholder who is an individual may elect to be taxed upon any undistributed income of a controlled foreign corporation attributed to him as if he were a corporation rather than an individual. If he makes this election this means that he will be subject to a 30-percent tax on the first $25,000 of undistributed income allocated to him and a 52-percent tax on all income allocated above this level. Against this 52-percent or 30-percent tax rate, credits will be allowed for income and other creditable taxes paid by the controlled foreign corporation to foreign countries in the same manner as if the individual were a domestic corporation.

The purpose of this provision is to avoid what might otherwise be a hardship in taxing a U.S. individual at high bracket rates with respect to earnings in a foreign corporation which he does not receive. This provision gives such individuals assurance that their tax burdens, with respect to these undistributed foreign earnings, will be no heavier than they would have been had they invested in an American corporation doing business abroad.

If an individual has elected with respect to the earnings of a controlled foreign corporation to be treated as if he were a domestic corporation, and then subsequently an actual distribution is made, the bill provides that he then is to be taxed only on the excess of the amount received over the amount of taxes he previously paid with respect to the undistributed income. Therefore, if the individual were to be taxed on $100 of undistributed income at a 52-percent tax rate, and then subsequently the $100 was paid to him as a dividend, he would be taxed at individual income tax rates only on $48, namely, the excess of the amount distributed to him over the taxes he previously paid, assuming the foreign country involved had no income taxes.

Another relief provision is provided with respect to any undistributed income representing "foreign base company income." The bill provides that such income is not to be taxed to the U.S. shareholder if it is established to the satisfaction of the Secretary of the Treasury or his delegate that the incorporation of the controlled foreign corporation in the particular foreign country involved does not have the effect of substantially reducing income, excess profits or similar taxes.

9. Treatment provided in the case of Puerto Rico and U.S. possessions.—The bill provides that a controlled foreign corporation does not include a corporation incorporated in Puerto Rico or a possession of the United States if 80 percent or more of the gross income of the corporation (for the prior 3-year period) is derived from sources within Puerto Rico or a possession of the United States, and if 50 percent or more of the gross income was derived from the active conduct within Puerto Rico or a possession of the United States of specified trades or businesses. The trades or businesses qualifying are the following:

(1) manufacturing and processing of goods or other tangible personal property,

(2) the processing of agricultural or horticultural products (including livestock, poultry, or fur-bearing animals),

(3) the catching of fish (whether or not on the high seas) or extraction of natural resources, or the manufacturing or processing of commodities obtained from such activities, or

(4) the ownership or operation of hotels.

Your committee has excluded Puerto Rico and U.S. possession corporations from the operation of section 12 in recognition of their special status and our special interest in encouraging investments in such areas. The definition of the excluded corporations parallels (except for the reference to the specific trades or businesses) the provision in existing law which excludes from U.S. tax qualifying businesses carried on in the possessions.

In addition to excluding these Puerto Rican or U.S. possessions corporations from the application of section 12, your committee has also provided that the term "U.S. person" (and, therefore, the term U.S. shareholder) does not include in the case of a corporation organized under the laws of Puerto Rico an individual who is a bona fide resident of Puerto Rico (within the meaning of sec. 933(1)); with respect to a corporation organized under the laws of the Virgin Islands does not include an individual who is a bona fide resident of the Virgin Islands and whose income tax obligation is satisfied by paying tax on income derived from all sources into the treasury of the Virgin Islands and in the case of a corporation organized under the laws of any other possession, does not include a bona fide resident of that possession (qualifying under sec. 932(a) of the code).

The effect of not treating these bona fide residents as U.S. persons is to provide that they do not qualify as U.S. shareholders in determining whether or not more than 50 percent of a foreign corporation is controlled by 10-percent U.S. shareholders.

10. Miscellaneous provisions.—

a. Foreign tax credit.—U.S. shareholders who are taxed on subpart F income, on a decrease in investments in less developed countries, or on the increase of earnings invested in U.S. property, can obtain a foreign tax credit for foreign income, etc., taxes paid by the foreign corporation, if the shareholder is a person to whom such a foreign credit would be allowed in the case of an actual distribution. That means that foreign tax credits will be allowed where the shareholder is a domestic corporation (or an individual electing to be treated as a domestic corporation) holding the stock of a foreign corporation and has at least a 10-percent voting stock interest. Similarly, where a domestic corporation has at least a 10-percent interest in a foreign corporation which in turn has at least a 50-percent voting stock interest in a subsidiary, then a foreign tax credit will be allowed the U.S. shareholder with respect to the earnings of this subsidiary when undistributed earnings of the subsidiary are taxed to the U.S. corporate shareholder. Taxes so allowed as credits will not again be allowed as credits when actual distributions are made.

Where the foreign country imposes a tax directly on dividend distributions, such a tax would not, of course, initially be taken into account when the shareholder at an earlier date was taxed on undistributed earnings of a controlled foreign corporation. These taxes on actual dividend payments, however, will be allowed as credits in the year in which the actual dividends are paid, even though these dividends are not taxable to the domestic corporation receiving them because of an earlier inclusion by it of these amounts in its income. Adjustments are made in the overall and per country limitations to keep these limitations from reducing the creditable taxes in such cases below what could be credited if the income taxed and taxes attributable to this income had been taken into account in the same year. Moreover, if the taxpayer has insufficient U.S. income tax against which to offset such credits in the year of the actual distribution, then refunds are allowed.

b. Adjustments to basis of stock.—It is necessary where amounts not actually distributed to the taxpayer are nevertheless taxed to him, to increase his basis for the stock in the controlled corporation by the amount so taxed to him. However, if subsequently actual distributions are made which do not result in any tax to the shareholder because of the prior tax payment by him, then the basis of the stock needs to again be reduced. The bill makes provision for these adjustments.

c. Other provisions.—The bill provides that earnings and profits of a foreign corporation for purposes of this provision are to be determined according to rules substantially similar to those applicable to domestic corporations under regulations prescribed by the Secretary or his delegate. The bill provides that earnings and profits of a controlled foreign corporation are not to be taxable to the U.S. shareholder when it is established to the satisfaction of the Secretary or his delegate that such earnings are blocked because of currency or other restrictions or limitations imposed by the laws of any foreign country.

11. Effective date.—This provision applies to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of U.S. shareholders within or with which these taxable years of the foreign corporations end.

XIII. GAIN FROM DISPOSITION OF CERTAIN DEPRECIABLE PROPERTY

(Sec. 13 of bill and secs. 1245, 167(f), 170(e), 453(d) and 613(a) of code)

A. Reasons for provision

Under present law, in the case of depreciable property the taxpayer may write off the cost or other basis of the property over the period of the useful life of the asset in his hands. This cost or other basis can be written off evenly (i.e., in a "straight line" over the asset's life), under the declining balance method, under the sum-of-the-year's digits method, or under any other consistent method which does not during the first two-thirds of the useful life of the property exceed the allowances which would have been allowed under the declining balance method. The depreciation deduction is a deduction against ordinary income. If either the useful life of the asset is too short, or the particular method of depreciation allows too much depreciation in the early years, the decline in value of the asset resulting from these depreciation deductions may exceed the actual decline. Wherever the depreciation deductions reduce the basis of the property faster than the actual decline in its value, then when it is sold there will be a gain. Under present law this gain is taxed as a capital gain, even though the depreciation deductions reduced ordinary income. The taxpayer who has taken excessive depreciation deductions and then sells an asset, therefore, has in effect converted ordinary income into a capital gain.

The President stated that our capital gains concept should not encompass this kind of income. He indicated that this inequity should be eliminated, especially in view of the proposed investment credit for newly acquired property. He states that we should not encourage the further acquisition of such property through tax incentives as long as the loophole remains.

This problem also is of major significance in connectoin with the recent depreciation liberalization announced by the Treasury Department. Under this new approach, many taxpayers will be permitted to depreciate assets faster for tax purposes than has previously been the case. Therefore, additional ordinary income would be converted into capital gain if this were not dealt with in this provision.

B. Comparison of committee amendments with House provision

Both the House bill and your committee's amendments treat as ordinary income any gain on the sale or other disposition of certain depreciable property to the extent of the depreciation deductions taken. However, this treatment will apply to property subject to the allowance for depreciation which is either (1) personal property or (2) certain other tangible property but not including a building or its structural components. The bill as passed by the House did not apply this treatment to buildings or structural components thereof, and your committee has not changed this feature of the House-passed bill.

The House bill applied to property disposed of after the date of enactment of this bill and provided that the only gain which was to be treated as ordinary income was to be depreciation occurring in 1962 and subsequent years. The bill, as amended by your committee, will only apply to sales, exchanges, or other dispositions occurring during taxable years beginning after December 31, 1962. However, as under the House bill, in such dispositions, depreciation occurring in 1962 and subsequent years will result in ordinary income.

Your committee concurs with the House in believing that the new treatment of gain on sale will make it possible to be more lenient in determining salvage value. The bill as passed by the House provided that the salvage value for depreciation purposes of an asset may be reduced by up to 10 percent of its cost or other basis, and if this value is less than 10 percent of basis it may be disregarded altogether.

The bill as passed by the House provides that for a period of time after the new ordinary income treatment becomes applicable, taxpayers will have a new election to change their method of depreciation from any declining balance or sum-of-the-years digits method to the straight-line method. This provision has been retained by your committee.

The above description has been in terms of the sale or exchange of a depreciable asset. There are, of course, other methods of disposing of an asset which also are dealt with in this provision. In the case of a gift or a transfer at death no gain is recognized at the time of the disposition of the asset. In the case of a gift, however, the ordinary income potential of the depreciation deductions carries over into the hands of the donee. In the case of gifts to charity, although no ordinary income is recognized at the time of the gift, the charitable contribution is reduced by the amount which would be recognized as ordinary income if the property were sold. Generally, in other cases any gain which under present law would be recognized at the time of the disposition of an asset will be treated as ordinary income to the extent of any depreciation deductions taken. In certain cases, however, in order to prevent tax avoidance the bill provides for the recognition of ordinary income on the disposition of an asset even though gain might not otherwise be recognized. This is true in certain cases where a distribution is made by a corporation or partnership. These provisions have been accepted by your committee.

Your committee has, however, added a new provision providing for an appropriate adjustment in computing the "taxable income from the property" for purposes of the limitation on percentage depletion in the case of mining. This provision is explained below.

C. General explanation of provision

1. *General rule.*—The general rule (in sec. 1245) provides that ordinary income is to be recognized in the case of sales or exchanges to the extent the so-called recomputed basis, or the amount realized in the sale or exchange, whichever is lesser, exceeds the basis of the property in the hands of the person making the sale or exchange. "Recomputed basis" is defined generally as equaling the adjusted basis plus the depreciation deductions previously taken. The excess of the amount realized over the adjusted basis is, of course, the amount presently recognized as capital gain. Since the rule requires that the smaller of these two amounts be treated as ordinary income, this in effect means that the ordinary income in the usual case is to be the gain realized or the sum of the depreciation deductions taken, whichever is the smaller. Where there is a disposition of an asset without a sale or exchange, gain is determined by reference to the fair market value of the asset.

Since this provision is to have prospective application only, in computing depreciation for this purpose only depreciation deductions occurring after December 31, 1961, are to be taken into account. Depreciation deductions for this purpose include not only regular depreciation deductions but also the special initial allowance deduction and any deduction for the amortization of emergency facilities. The special reduction in basis of property provided in connection with the investment credit (sec. 2 of this bill) is not, however, treated as a depreciation deduction for this purpose. Therefore, any gain on sale attributable to this basis adjustment will still result in capital gain (if gain from the property otherwise would be capital gain). The depreciation deductions taken into account are not limited to those taken by the taxpayer, but also include deductions taken by others from whom the taxpayer acquired the property, if the basis of the property was carried over from the transferor. This would not be true where the taxpayer acquired the property from another by reason of the latter's death, since in this case the property receives a new basis at death and this provision does not apply. The general rule is that the depreciation deduction taken into account for each year is the amount allowed or allowable whichever is greater. However, a special rule provides that the depreciation deductions taken into account as to any year will be the amount "allowed" rather than the amount "allowable" if the former is smaller and the taxpayer can establish what the amount was.

The type of property receiving the ordinary income treatment described above is (1) personal property (other than livestock), including intangible personal property, and (2) other property which is tangible, not including a building or its structural components, which is an integral part of certain specified business activities or which constitutes research or storage facilities used in connection with these activities. The activities specified are manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services.

The ordinary income treatment provided by this section will be applied upon the sale of all property the acquisition of which could have resulted in an investment credit (sec. 38 of the code as added by this bill). However, the ordinary income treatment may also apply to the disposition of property even though the acquisition of this specific property did not result in an investment credit. For example, no investment credit may have been allowed upon the acquisition of the property because (1) its expected useful life was less than 4 years; (2) it was to be used outside of the United States; (3) it was to be used by tax-exempt organizations or governmental units; or (4) it was not new when acquired (and was over the $50,000 limit), etc.

2. *Exceptions.*—Except as specifically provided in the bill, the ordinary income treatment applies at any time property is disposed of. The bill, however provides six general categories of exceptions to this rule. The first exception is for gifts. As pointed out above, however, the depreciation deductions of the donor must be taken into account by the donee, and may result in ordinary income to him if he sells the property. In the case of depreciable property which is given to a charitable organization, although no income is realized by the donor at the time of the gift, the amount of the charitable contribution deduction he may receive is reduced by the amount which would have

been treated as ordinary income had the property been sold at its fair market value (an amendment adding a new sec. 170(e)).

A second exception to the realization of ordinary income upon the disposition of depreciable personal property is provided in the case of transfers at death (except where the sale has occurred before death and the income is treated as income in respect of a decedent under sec. 691). In this case, however, there is not a carryover of the income potential in the depreciation deductions to the decedent's legatee or heir.

A third category of exceptions to the realization of ordinary income is provided in the case of a series of transactions which generally are tax free and in which the basis is carried over. However, in these transactions where there is any gain recognized, because the exchange is accompanied by "boot" (i.e., money or its equivalent) then to the extent of this gain, ordinary income may be realized (unless the depreciation deductions are smaller). The tax-free transactions referred to relate to those occurring upon the complete liquidation of a subsidiary (sec. 332); in the case of a transfer for stock or securities to a corporation controlled by the transferor (sec. 351); in the case of a transfer by a corporation which is a party to a reorganization of property in pursuance of a plan of a reorganization solely for stock or securities in another corporation also a party to the reorganization (sec. 361); and in the case of reorganizations in certain receivership and bankruptcy proceedings (sec. 371(a) and sec. 374). Also included in the same category are contributions of property to a partnership in exchange for an interest in the partnership, and distributions by a partnership in partial or complete liquidation of an interest (but in this respect see the special partnership treatment described below). Despite the above rule there would be a recognition of ordinary income where there is a contribution of depreciable property to a tax-exempt organization (other than a tax-exempt farm cooperative) in exchange for stock or securities in the exempt organization. Recognition of ordinary income in this case is provided because a disposition of the property by the exempt organization would not ordinarily give rise to the realization of ordinary income with respect to the depreciation deductions.

Another exception is provided in the case of so-called like kind exchanges of property used for production or investment, and for involuntary conversions. In exchanges of these types, the ordinary income realized is not limited to any gain recognized, but also includes gain taking into account the fair market value of nondepreciable or other nonqualifying property acquired in exchange for depreciable property. The realization of ordinary income (to the extent of the depreciation deductions) is necessary in such cases since in the case of property, other than depreciable personal property, there is no opportunity for subsequent recovery of the ordinary income element. A similar exception is provided in the case of the exchange or sale of property in obedience to Federal Communications Commission orders or orders of the Securities and Exchange Commission (secs. 1071 and 1081). In these cases also, the ordinary income realized is not limited to the gain recognized, but also includes any unrecovered depreciation charges with respect to exchanges of depreciable personal property for other types of property.

Special rules are also provided in the case of distributions of depreciable personal property by a partnership to a partner. A distribution of depreciable personal property by a partnership to a partner, to the extent that the distribution accounts for the partner's share of gain attributable to this property, is not to result in ordinary income to the distributee partner at the time of the distribution. However, the ordinary income potential of depreciation deductions taken by the partnership (or by any earlier transferee from whom the partnership acquired property without realization of gain) will be carried over to the distributee partner. When he disposes of this property, the ordinary income potential of these partnership (or prepartnership) depreciation deductions will be taken into account in a manner substantially the same as that applying where the taxpayer himself took the depreciation deductions. The property distributed is given a "recomputed basis" to the partner equal to the basis of the property in the hands of the partner plus any ordinary income gain on which the partnership would have been taxed had the property been sold by it (at its fair market value) immediately before the distribution.

The rule described above applies only to the extent a partner is considered as receiving his share of the property representing ordinary income gain. An amendment made elsewhere to the code (sec. 751(c)) provides that in other cases the ordinary income element in depreciable property is to be considered as an "unrealized receivable." Thus, to the extent of depreciation deductions taken (or potential gain if smaller) ordinary income will be realized in the case of the sale of a partnership interest, in the case of a distribution to a retiring or deceased partner, and in the case of distributions to a partner where he receives either more or less than his proportionate share of property reflecting this type of gain.

3. *Dispositions resulting in ordinary income where no gain is presently recognized.*—In a series of situations your committee found it necessary to recognize ordinary income even though capital gain in such situations is not recognized under existing law. This was done primarily in those cases where the transferee receives another basis for the property than that of the transferor. This treatment is provided in three types of cases where a distribution is made by a corporation without the payment of a tax at the corporate level on unrealized appreciation in value: namely, where the property is distributed as a dividend (under sec. 311), where the property is distributed in a partial or complete liquidation by a corporation (sec. 336), and where in a plan of complete liquidation a corporation sells the depreciable personal property (and perhaps other assets) and within a 12-month period completes the liquidation of the corporation (sec. 337). Similarly, if the property is first sold by a corporation for installment notes and the gain which would be realized on such sale is delayed because of the installment method of reporting, a distribution of these notes to the shareholders in a liquidation under section 337 (12 months' liquidation) results in the recognition of the same amount of ordinary income to the corporation as would have been realized on a cash sale of such notes. The same rule is applied whenever similar installment notes are distributed by a corporation in a liquidation in which the basis of the property to the receiving shareholder is determined under section 334(b)(2) (purchase of 80 percent of the stock of one corporation by another followed by

the immediate liquidation of the corporation acquired). The other situations where ordinary income may be realized under this provision, although capital gain would not otherwise occur, include the case where a distribution is made by a partnership and the partner gives up, or acquires, more than his proportionate share of this property. Other cases involve the provisions relating to the exchange of "like kind" property, involuntary conversions, sales or exchanges to effectuate FCC policy, and exchanges in obedience to orders of the SEC. In all of these cases where the property received in exchange for depreciable personal property is not itself depreciable personal property, then ordinary income is recognized.

4. Computation of taxable income for purpose of limitation on percentage depletion deduction.—The attention of your committee was called to the fact that the House bill worked a hardship on certain mining properties. At the time the depreciation deductions were initially taken they reduced the "taxable income from the (mining) property." Because percentage depletion deductions are limited to 50 percent of the taxpayer's taxable income from the mining property, in many cases this meant smaller deductions for percentage depletion. Under the House bill part of these depreciation deductions were recouped as ordinary income at the time of the sale of the depreciable property but no comparable upward adjustment was made to the taxable income from the mining property for purposes of percentage depletion.

Your committee has removed this discrimination against mining properties by amending the percentage depletion provision of existing law (sec. 613(a)) to provide that for purposes of the limitation restricting the percentage depletion deduction to 50 percent of taxable income, this income, in case of mining, in effect is to be increased by the amount of gain taxed as ordinary income (under sec. 1245) which is allocable to the property. This increase in taxable income, however, is made *only* for purposes of computing taxable income from the property for the 50-percent limitation, and for no other purpose. The amendment is accomplished by reducing the deductions taken into account with respect to the expenses of mining, used in computing the taxable income from the property, by the portion of any gain treated as ordinary income. This avoids any effect on the computation of "gross income from property" (as defined in sec. 613(c)). No change is made in existing law with regard to the treatment of losses resulting from the sale of depreciable personal property used in exploiting a mineral property.

5. Salvage value.—The bill also amends the code (a new subsec. (f) in sec. 167) to provide that in computing the basis on which depreciation may be taken for personal property, salvage value may be ignored to the extent of an amount equal to 10 percent of the cost or other basis for the property. Thus, if the expected salvage value equals 8 percent of the basis of the property, the entire basis may be written off in depreciation charges by the taxpayer. If the expected salvage value is 12 percent, all but 2 percent of the basis of the property can be taken into account in computing depreciation charges. The provision applies to depreciable personal property (other than livestock) with a useful life of 3 years or more acquired after the date of enactment.

6. *Change in method of depreciation.*—Your committee recognized that some taxpayers who have been following liberal depreciation policies may desire to follow more conservative policies in order to avoid the possibility of ordinary income treatment at the time of sale, as provided by the bill. Therefore, the bill provides that a taxpayer may elect to change his method of depreciation with respect to depreciable personal property from any declining balance or sum of the years digit method to the straight-line method. The right to make this election will be available on or before the date for filing the return (including extensions of time) for the first taxable year beginning after December 31, 1962.

7. *Effective date.*—This provision is to apply with respect to depreciation attributable to periods after December 31, 1961, and as to dispositions of property during taxable years beginning after December 31, 1962. However, the provision relating to salvage value generally is effective for taxable years beginning after 1961.

XIV. FOREIGN INVESTMENT COMPANIES

(Sec. 14 of the bill and secs. 312(l), 1246 and 1247 of code)

A. *Reasons for provision*

For the small investor who desires to diversify his shareholdings through the use of domestic mutual funds, or regulated investment companies, present law provides that if a series of conditions are met, including the distribution of at least 90 percent of the earnings of the regulated investment company, no tax is imposed on the investment company to the extent it distributes its earnings. Thus, if a domestic company distributes its income currently, present law provides for the imposition of a single, rather than a double, tax, and that one is imposed on the investor rather than the company.

Increasingly in recent years, however, some taxpayers have sought to avoid this tax by investing in foreign investment companies rather than domestic companies. Under present law a foreign investment company usually pays no U.S. income tax, since U.S. tax is imposed only on income derived from sources within the United States and such companies generally have no U.S. securities and, therefore, have no income from U.S. sources. The U.S. shareholders of one of these investment companies are likely to pay a U.S. tax with respect to such investments only when they sell the stock and then, of course, this gain is taxed as a capital gain rather than ordinary income. The U.S. shareholder would, of course, pay tax on any dividend income received from such a company, but most of these companies follow the announced policy of reinvesting all of their income in stocks or bonds in order to prevent the imposition of any such dividend tax by the United States.

The tax avoidance occurring in the case of these foreign investment companies is a matter to which study has been given since 1956. Since that time the seriousness of this problem has increased substantially. The Secretary of the Treasury in his testimony before your committee stated:

> 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.

It was proposed by the administration that the preferential treatment for investments in these foreign investment companies be eliminated by requiring U.S. shareholders in such companies to pay tax currently on their share of the income derived from the foreign investment company. The provisions included in the House bill achieve much the same result but without attempting to look through the foreign corporation to the American shareholders.

The House bill in general terms provides that American shareholders in these foreign investment companies, when they sell or redeem their stock, are to be taxed at ordinary income rates on their share of any earnings and profits accumulated in the foreign investment company since December 31, 1962, or since the date they acquired the stock, whichever occurred more recently. However, it also provides that this treatment can be avoided at the election of the foreign investment company if it distributes 90 percent of its taxable income other than net long-term capital gains currently and if it informs the U.S. shareholders of their share of any net long-term capital gains. However, for this treatment to apply, the U.S. shareholders must also include in income their share of capital gains whether or not distributed. The distributions of ordinary income in this case, since they are actual distributions, would, of course, in any case be reported for tax purposes by the U.S. shareholders.

B. Comparison of committee amendments with House provision

Your committee has retained the House provision on foreign investment companies with three relatively minor modifications.

Your committee recognized that with the removal of the tax advantages for these corporations in being foreign corporations, many of them may desire to become domestic corporations treated as regulated investment companies. However, under present law when a foreign corporation is a party to a reorganization in which all of its properties are acquired by a domestic corporation, clearance must be obtained from the Internal Revenue Service to the effect that the reorganization is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Failure to obtain such a clearance results in the imposition of capital gains tax on any appreciation of value. Since your committee has allowed a foreign investment company which has been registered with the SEC the right to elect to have its shareholders treated in a manner substantially similar to that accorded to domestic regulated investment companies, it does not believe that there is tax avoidance if such a company is a party to a reorganization in which all of its properties are acquired by a domestic regulated investment company. Moreover, it believes that the conversion of these companies to domestic companies simplifies the operation of the tax laws in the case of their shareholders. For these reasons, it is provided that this clearance from the Internal Revenue Service under section 367 need not be obtained in the case of one of these foreign investment companies registered with the SEC if it is a party to a reorganization in which all of its properties are acquired by a domestic regulated investment company before January 1, 1964. However, this treatment is to be available only if, for the year 1963, the corporation elected to distribute at least 90 percent of its ordinary income to its shareholders and either distribute, or treat as distributed, the excess of its net long-term capital gain over its net short-term capital loss.

The election provided foreign investment companies by the House bill, to distribute most of their ordinary income currently and to require their shareholders to report their share of the company's capital gains (whether distributed or not), provides tax treatment for these foreign investment companies which is substantially similar to that now applicable to domestic regulated investment companies. However, where domestic regulated investment companies have more than 50 percent of their assets invested in securities in foreign corporations, present law permits the foreign tax credit, for which the regulated investment company itself would otherwise be eligible, to be passed on down to the shareholders. Your committee's amendments, in the interest of conforming the treatment for these foreign investment companies to that provided for the domestic regulated investment companies, provides a similar option in their case to pass down through to the shareholders their foreign tax credits.

Your committee has also extended from 30 to 45 days the period of time elapsing after the end of the taxable year before the investment companies must report to their shareholders their share of the undistributed capital gains which they must take into account for tax purposes. Other technical changes are also made.

C. General explanation of provision

As indicated above, the bill provides alternative tax treatment for shareholders of foreign investment companies. Unless an election is made to the contrary, ordinary income treatment, to a limited degree, is provided at the time an investor in a foreign investment company either sells his stock or it is redeemed. However, if the company has elected to distribute most of its taxable income and the shareholders report capital gain, whether or not distributed, then at their election the ordinary income treatment at the time of the sale of the stock is not to apply. These two alternative provisions are discussed below.

1. Ordinary income treatment on sale of stock.—The bill provides that on the sale or exchange of stock in a foreign investment company after December 31, 1962, any gain realized is to be treated as ordinary income, rather than a capital gain, to the extent of the taxpayer's share of the company's earnings and profits accumulated in years beginning after December 31, 1962. For this purpose the taxpayer's share of these earnings and profits is limited to those attributable to his stock which have been accumulated during the period he has held the stock (excluding any earnings taxed to him when the company was a foreign personal holding company or a controlled foreign corporation). Had the company been a domestic company, currently distributing most or all of its earnings, these same earnings would have been taxable to him. Thus, this provision is not designed as a penalty tax, but merely to accord, to the extent practicable, the same tax treatment as that provided for domestic regulated investment companies.

To give assurances that this ordinary income will not escape tax where the shareholder holds the stock until death, the bill provides that the step-up in basis, or increase in value, which would otherwise occur at date of death is not to occur with respect to the amount which would be ordinary income to the decedent had he sold the stock just before death. Thus, when the estate, heir, or legatee sells the stock, the same amount (assuming the stock has not gone down in value) will still result in ordinary income and will be subject to U.S. tax at that time. However, the estate, heir, or legatee in such a case can treat this as "income in respect of a decedent." Thus, in computing his ordinary income tax he will be allowed a deduction for any estate tax attributable to inclusion in the decedent's estate tax base of the amount taxed as ordinary income.

Without regard to this provision, where a shareholder sells or exchanges stock in one of these foreign investment companies after holding it for not more than 6 months, the gain is short-term capital gain. Since this type of gain is treated much like ordinary income for tax purposes, the bill provides that if stock in a foreign investment company is held for 6 months or less the provision is not to apply.

A foreign investment company, for purposes of this provision, is defined as a foreign corporation, either registered under the Investment Company Act of 1940 as a management or unit investment trust, or any other corporation engaged primarily in the business of investing, reinvesting, or trading in securities where more than 50 percent of the voting stock (and total value of all shares) is held directly or indirectly by U.S. persons. "United States persons," a definition added to the code by the foreign trust provision in this bill (sec. 7), means a citizen or resident of the United States, a domestic partnership, a domestic corporation, and a domestic estate or trust.

To prevent avoidance of this ordinary income tax treatment through the use of tax-free (or partially tax-free) exchanges in which stock in a foreign investment company is exchanged for other stock (in a tax-free incorporation or contribution to capital under sec. 351), the bill provides that the substituted stock in such a case (where its basis is determined by reference to the basis of stock in a foreign investment company) is to be treated substantially as if it were the foreign investment company stock. Thus, upon its sale, any gain to the extent of the appropriate share of the foreign investment company's earnings and profits during the period it and the substituted stock was held is to be treated as ordinary income.

The bill also contains several other provisions similarly designed to prevent the avoidance of the ordinary income treatment through indirect ownership of the foreign investment company stock through certificates in a trust, through stock in a domestic corporation, or through a partnership. In this respect it is provided first that a share of stock in a domestic corporation or a trust certificate is to be treated as foreign investment company stock to the extent it represents such stock. Secondly, it is provided that if a company is a member of an affiliated group (with a 50-percent rather than an 80-percent stock-ownership requirement), then the earnings and profits of the entire group are to be allocated under regulations prescribed by the Treasury Department in a manner to carry out the purposes of the bill. Thus, where a foreign corporation is a holding company in the sense that it holds the stock of one or more foreign investment companies, the shareholders of the holding company will not be permitted to avoid ordinary income on the sale of the foreign holding company stock merely because the earnings and profits of the investment company (or companies) have not been distributed to the holding company. Thirdly, the bill provides that the ordinary income treatment is to apply to redemptions of stock by a foreign investment company which would otherwise be treated as sale transactions because of section 302(a) (disproportionate buy-out of a shareholder) or because of section 303 (a redemption of stock to pay death taxes). Finally, the bill deals with the sale or exchange of and also certain distributions with respect to partnership interests. The bill provides that if any of the property of the partnership is stock in a foreign investment company and would have resulted in ordinary income had it been sold by the partnership itself, then this amount is to be treated as an inventory item. Thus, the sale of the partnership interest (and distributions in certain cases) will generally result in the incurring of ordinary income treatment with respect to the foreign investment company stock underlying the partnership interest.

The bill provides that the shareholder upon sale of the stock must establish the amount of the accumulated earnings and profits of the foreign investment company and his share of these earnings during the period of his investment. If he does not do so, the entire gain will be treated as ordinary income. This information, of course, is necessary to determine the amount subject to ordinary income tax. In addition, the bill provides that every U.S. person owning 5 percent or more in stock of a foreign investment company is to furnish with respect to such a company such information as the Secretary of the Treasury deems necessary in order to properly enforce the tax provisions applicable to shareholders of these companies.

Your committee's amendments also provide that the clearance of the Internal Revenue Service, required by section 367 of the code, need not be obtained where a foreign investment company registered under the Investment Company Act of 1940 is a party to a reorganization in which all of its properties are acquired before January 1, 1964, by a domestic regulated investment company. However, for this clearance not to be required in such cases the foreign investment company must have elected to distribute most of its income currently (as provided under sec. 1247) for its taxable years beginning after December 31, 1962.

2. Election to distribute income currently.—Foreign investment companies which are registered with the SEC to sell stock in this country can elect to make the provision described above inapplicable under certain conditions. Any such election must be made before December 31, 1962.

For the provision referred to above to be inapplicable the electing foreign investment company must agree with respect to the current and all subsequent years to—

(1) distribute 90 percent of its taxable income to its shareholders. This is exclusive of capital gains.[1] Also, such a corporation can elect to treat as distributed during the year distributions made in the first 2½ months after the end of the year.

(2) designate in written notices mailed to its shareholders their shares of the excess of net long-term capital gains over net short-term capital losses, and the portion, if any, which the corporation has distributed. These notices must be mailed to the shareholders within 45 days after the close of the taxable year.

(3) provide such information as the Treasury Department considers necessary to carry out the purposes of this provision.

[1] For this purpose, as in the case of domestic regulated investment companies, no net operating loss carryover is allowed and no organizational expense deduction is allowed.

In addition to the corporation's fulfilling these requirements, however, the shareholder (who is a U.S. person), if he is to avoid the ordinary income treatment upon the sale of his stock, also must include in his income for tax purposes the excess of the net long-term capital gain over the net short-term capital loss, which the company in its notice to him designated as being his share of the company's capital gains. If the shareholder does not do so for any year, unless this failure was due to reasonable cause and not to willful neglect, the election provided by this provision will not apply when he sells or otherwise disposes of his stock. Thus, although other shareholders might continue to qualify in such a case, the shareholder who did not report this capital gain income, upon his sale of the stock will have ordinary income (limited as indicated above). It is not made a condition of qualification that the shareholder in such a case report his share of the ordinary income of the corporation. However, since at least 90 percent of his share of this income will actually be distributed to him, it must in fact be reported by him, in the same manner as any other dividend income which he may receive from foreign sources.

The bill provides that qualified shareholders are to include in computing their long-term capital gains both the distributed and the undistributed portions of the excess of net long-term capital gains over net short-term capital gains.

The bill further provides that the capital gains, reported by the shareholders, which are not actually distributed, are to result in a decrease in earnings and profits of the corporation for the shareholders who report them and also that the basis that they had for the foreign investment company stock is to be increased by this amount.

The bill also provides that if a foreign investment company has more than 50 percent of the value of its assets invested in securities of foreign corporations and it is registered under the Investment Company Act, it may elect to itself forego any foreign tax credits and instead pass these credits on to its shareholders on a pro rata basis. In such cases the shareholder takes both the dividends and his share of the taxes into his income and then claims a credit against tentative tax for the foreign taxes, subject to the same limitations as if he had paid them directly.

The election to distribute income currently with respect to the foreign investment company continues until the company fails to comply with the three conditions set forth above, unless the company becomes a foreign personal holding company, or no longer is a foreign investment company.

To prevent the use of the capital gains designating provision as a means of obtaining short-term capital losses which may be short-term capital gains or under certain circumstances ordinary income, merely at the cost or reporting a capital gain under this provision, the bill provides that if the shareholder has held the stock for less than 6 months, then any loss realized on the sale of the stock within that 6-month period is to be treated as if it were a long-term rather than short-term capital loss.

3. Effective date.—The amendments made by this provision apply to taxable years beginning after December 31, 1962.

XV. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

(Sec. 15 of bill and sec. 1248 of code)

A. Reasons for provision

Under existing law, through an ordinary taxable liquidation or sale or exchange, it is possible to bring earnings accumulated by a foreign corporation back to this country merely by paying a capital gains tax on such earnings included in the gain. Theoretically it is also possible to bring earnings accumulated by a foreign corporation back to the United States without payment of income tax through the use of a tax-free reorganization (under sec. 368) or through the use of a tax-free liquidation (under sec. 332). However, to do so the Commissioner of Internal Revenue must give clearance by determining in advance that the transaction "is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." Generally the Commissioner has been unwilling to grant such approval where there is an appreciable amount of earnings and profits accumulated in a foreign corporation.

The bill has as one of its objectives in the foreign income area the imposition of the full U.S. tax when income earned abroad is repatriated. Full U.S. taxation will occur in the case of the ordinary taxable liquidations or sales or exchanges only if the earnings and profits are in effect taxed as dividends (to the extent of any gain) at the time the funds are brought back to the United States. This objective is accomplished by this section of the bill.

B. Comparison of committee amendments with House provision

Your committee has retained the basic structure of the House bill but has made a number of important modifications in it, which are discussed below.

Under the bill as passed by the House, amounts (to the extent of undistributed earnings) received by an individual or corporate stockholder on the *sale* of the stock (as distinguished from a redemption) were treated as ordinary income and not as dividends. Under your committee's amendments, the appropriate portion of the gain on a sale is also treated as a dividend.

Under the bill as passed by the House, no special treatment was provided for individual shareholders of controlled foreign corporations. They were required to take into their tax base as ordinary income the entire gain in the year recognized. This meant the income might, because of "bunching," be taxed at unusually high rates. Moreover, the individual might be treated much worse than if the corporation had been a domestic corporation subject to the U.S. corporate tax, against which foreign tax credits could be taken, and then the balance distributed and taxed to the individual at capital gains rates. Under your committee's amendments, if the shareholder is an individual his tax (on either a redemption or sale) is to be no greater than that provided under the lower of two ceilings. The first ceiling provides that the individual's tax is to be no greater than if the foreign corporation had been a domestic corporation paying the regular U.S. corporate tax (offset by foreign tax credits allowable to a corporation) which then made a liquidating distribution of the balance to the U.S. shareholder and this balance was subjected to capital gains tax. In other words, this ceiling would provide a U.S. tax of no more than 52 percent against which foreign tax credits are taken, plus a capital gains tax on the remaining 48 percent at not more than 25 percent. Thus, the aggregate maximum tax could never be more than 64 percent (52 percent plus 25 percent of 48 percent). The second ceiling is an averaging device. It provides that the tax is not to exceed the amount which would have resulted had the earnings and profits been distributed to the shareholder in the years they were earned.

Your committee has also amended the House bill to provide that earnings and profits are not to include profits on sales made during a liquidation if the corporation could have qualified for tax-free sales on liquidation if it had been a domestic corporation.

In addition, your committee has amended the section to provide that it is not to apply to earnings and profits accumulated by a foreign corporation while it was a less developed corporation if the stock sold or exchanged was owned for at least 10 years before the date of sale or exchange by the U.S. shareholder.

Your committee has also amended the House bill to provide that the ordinary income treatment provided by this section is in no case to apply to earnings and profits accumulated in taxable years beginning before January 1, 1963. Under the House bill the ordinary income treatment could apply to earnings and profits accumulated since February 28, 1913.

C. General explanation of provision

The provision as amended by your committee applies to any shareholder who owned 10 percent or more of the total combined voting power of the stock of a foreign corporation at any time during the 5-year period ending on the date of exchange but only if the corporation was a controlled foreign corporation at any time during the period the stock was owned by the shareholder. (The 10-percent ownership is determined under the constructive stock ownership rules in sec. 958(a) as added by this bill.)

The section applies to any sale or exchange or to any surrender of stock to the corporation for redemption in a transaction which would be treated as a sale or exchange under section 302 or section 331 (a buy-out or a total or partial liquidation). If such a sale, exchange or redemption occurs, and there is a gain on the transaction, there is included in the gross income of the person surrendering the stock, as a dividend, the portion of such gain attributable to the earnings and profits of the foreign corporation allocable to the stock surrendered, accumulated while the shareholder held the stock during a period in which the corporation was a controlled foreign corporation, in taxable years beginning after December 31, 1962.

If the shareholder surrendering the stock is a corporation, it is entitled to a credit for foreign taxes paid by the foreign corporation in the same manner and to the same extent as it would be entitled to such credit in the case of any other dividend received from a foreign corporation.

If the shareholder is an individual, the tax to be paid by him shall not be greater than either the "domestic corporation limitation" or the "annual distribution limitation," whichever is the lesser.

The "domestic corporation limitation" is the sum of—

(1) the excess of the U.S. income taxes which would have been paid by the foreign corporation with respect to its income if it had been a domestic corporation over the foreign income taxes actually paid by such corporation, and

(2) the amount of capital gains tax which would have resulted to the shareholder on the surrender of his stock, if the amount actually received by him on such surrender were diminished by the amount described in (1) above.

The "annual distribution limitation" is the amount equal to the aggregate of taxes which would have been attributable to the amount treated as a dividend had it been distributed to the shareholder as a dividend in the year or years in which it was earned.

The earnings and profits for purposes of this section do not include any amount attributable to gains on sales made in the course of a liquidation if these sales would have been treated as tax-free sales on liquidation (under sec. 337(a)) had the foreign corporation been a domestic corporation.

This section does not apply to earnings and profits accumulated by a foreign corporation while it was a less developed country corporation (as defined in sec. 955(c), as added by the bill), if the stock sold or exchanged was owned for at least 10 years by the U.S. persons before the date of the sale or exchange. A transfer of stock by death is viewed as not interrupting the continuous ownership.

This section also provides that any item of gross income of the foreign corporation treated as income derived from sources within the United States is not to be included in the earnings and profits to be taken into account.

This section also contains provisions providing that earnings taxed once under other sections (secs. 951 and 1247) will not be taxed a second time by virtue of this section.

This provision does not apply to distributions to pay death taxes (sec. 303) or to gain realized because of "boot" on a reorganization exchange (sec. 356). It likewise does not apply to any amount which is treated as a dividend, as a gain from the sale of an asset which is not a capital asset, or as a short-term gain under any other section of the code.

This section provides that unless the taxpayer establishes the amount of the earnings and profits of the foreign corporation to be taken into account, the entire gain from the sale or exchange is to be considered a dividend.

This section will apply to sales or exchanges made after December 31, 1962, with regard to earnings and profits accumulated in taxable years beginning after that date.

XVI. SALES AND EXCHANGES OF PATENTS, ETC., TO CERTAIN FOREIGN CORPORATIONS

(Sec. 16 of bill and sec. 1249 of code)

A. *Reasons for provision*

The House bill in section 13 (now sec. 12 in your committee's amendments) contained a provision which included in the income of 10-percent shareholders of controlled foreign corporations, income of those corporations which arose from patents, copyrights, and exclusive formulas and processes which have been substantially developed, created, or produced in the United States or acquired from related U.S. persons. The House provision taxed this income to the U.S. shareholders not only when it represented a royalty or similar payment received by the controlled foreign corporation, but also where this corporation itself used the patent, etc. in the manufacture of goods and derived income from the sale of the manufactured articles. In this latter case it would have been necessary to have constructed the income attributable to the patent, etc.

A considerable body of testimony before your committee indicated that it was impractical to attempt to determine this constructive income. Problems also arose, even in the case of royalty payments, in determining how much of the income was due to the patent, copyright, etc., and how much might be due to services rendered in connection with the use of such a patent, etc.

Therefore, your committee has deleted the part of the House provision attributing back to U.S. shareholders income from patents and related rights, and substituted a new provision which merely provides that when a patent, invention, etc., is transferred to a foreign corporation by a U.S. person controlling such corporation, that any gain otherwise recognized is to be ordinary income rather than a capital gain. An exception to this rule is provided where the transfer is to enable the foreign corporation to use the property in its own manufacturing operations. Gain coming under this exception will continue to be treated as capital gain. This amendment applies only in the case of transfers in taxable years beginning after December 31, 1962.

Your committee recognizes that the transfer of U.S. developed patent and similar rights by a U.S. corporation to a controlled foreign corporation causes a diversion of income from U.S. sources. It believes that taxing any gain on such transfer as ordinary income will, however, correct this situation as to such transfers in the future.

B. Comparison of committee amendments with House provision

As indicated above, section 13 of the House bill (sec. 12 under your committee's amendments) would have taxed income attributable to patents, copyrights, and exclusive formulas and processes substantially developed, created or produced in the United States or acquired from related U.S. persons as giving rise to income which, whether distributed or not, was to be taxable to U.S. shareholders of controlled foreign corporations. Your committee has deleted this provision and substituted the new provision which treats gains from the sale of patents, copyrights, etc., as ordinary income rather than capital gain when transferred by a U.S. person to a foreign corporation which it controls.

C. General explanation of provision

Your committee's amendments added a new section to the code providing that gain from the sale or exchange after December 31, 1962, of certain property rights to a foreign corporation by a U.S. person controlling that corporation is to be treated as ordinary income rather than as capital gain. The type of property, the transfer of which will lead to this ordinary income treatment, is—

(1) a patent,
(2) an invention,
(3) a model or design (whether or not patented),

(4) a copyright,
(5) a secret formula or process, or
(6) any other similar property right.

This ordinary income treatment, however, is not to apply in the case of gain realized from the sale or exchange for stock or contribution to capital of such property if it is established to the satisfaction of the Secretary of the Treasury or his delegate that the principal purpose of the transfer was to enable the foreign corporation to use the property in its own manufacturing operations.

For purposes of this provision, a U.S. person will be considered as controlling a foreign corporation if it owns directly or indirectly the stock possessing more than 50 percent of the voting power of all classes of stock entitled to vote. In determining the indirect ownership, certain constructive ownership rules (those in sec. 958) will be applied.

This provision is to apply to taxable years beginning after December 31, 1962.

XVII. TAX TREATMENT OF COOPERATIVES AND PATRONS

(Sec. 17 of the bill and secs. 1381 to 1388 of the code)

A. *Reasons for provision*

In 1951 Congress passed legislation which, taken together with prior Treasury rulings, it generally was thought insured that earnings of cooperatives would be currently taxable (to the extent they reflected business activity) either to the cooperatives or to the patrons. However, certain court decisions, notably the *Long Poultry Farm* and *B. A. Carpenter* cases, held that noncash allocations of patronage dividends generally were not taxable to the patron, although they were deductible by the cooperative.

The President recommended that what was thought to be the law in 1951 be provided specifically in the statute. Under the recommendation cooperatives would be allowed to deduct amounts allocated in cash or scrip as patronage dividends and patrons would be currently taxable on the patronage dividends allocated to them arising out of business activities.

The House bill adopts an approach which in substance is substantially the same as that recommended by the President. It provides that the cooperative is not required to take patronage dividends paid in money, qualified allocations, or other property, except nonqualified allocations, into account in determining taxable income. A deduction is also provided for the nonqualified allocations when they are redeemed. For the patron, the bill provides that these same amounts (to the extent not attributable to purchases for personal living expenses or capital items) are to be included in income for tax purposes in the year received (or in the case of a nonqualified allocation, when redeemed).

Qualified allocations for this purpose are defined by the House bill as including first, allocations which the patron can redeem in cash at their stated dollar amount at any time in the first 90 days after they are issued and second, qualified allocations which the patron has consented to take into account at their face amount as income (unless the patronage was with respect to personal living expenses or capital items). In the case of members, consent may be given by being a member of the cooperative if there is a provision in the bylaws requiring all members to agree to take the allocations into account. In the case of nonmembers (and members if the cooperative prefers) this consent can be provided by the patron signing an agreement to do so. (As explained subsequently your committee also provides another manner of obtaining the consent of the patrons.) Your committee agrees with the House that, since in the case of either the 90-day or consent allocation the patrons have constructively received the dividend and reinvested it, it should constitute income to the patron (where the patronage dividend arises from business activity) and should be taxable to him.

The House provision is effective for taxable years beginning after December 31, 1962, in the case of the cooperatives and in the case of patrons is effective with respect to amounts paid by the cooperatives in taxable years of the cooperative beginning after that date. Existing law will continue to apply with respect to allocations (including their redemption after the specified date) issued with respect to patronage in earlier taxable years to which the new provisions do not apply.

B. Comparison of committee amendments with House provision

Your committee has accepted the tax treatment outlined in the House bill for cooperatives and their patrons with two modifications. First, it is provided that at least 20 percent of patronage dividends must be paid in cash for the cooperative to receive any deduction with respect to their patronage dividends. Likewise, a 20-percent cash payment must be made for exempt cooperatives to receive a deduction for distributions out of nonpatronage earnings. Second, a new form of consent is provided, namely, the qualified check, which the cooperative may use.

The House bill provided for withholding on interest, dividends, and patronage dividends at the rate of 20 percent. Your committee's bill has substituted for the withholding provision a reporting system for dividends, interest, and patronage dividends. However, in the case of patronage dividends, withholding also served the purpose of providing the patron with at least enough funds to pay the full first bracket tax on any qualified allocations taxable to him. Your committee believes that it would be unfortunate to require the patrons to report these qualified allocations for tax purposes without being sure that the cooperative made available to the patrons enough cash to pay at least the first bracket income tax. To give assurance that the cooperative provides the patron with at least enough money to pay this first bracket tax, your committee has provided that cooperatives must pay at least 20 percent of their patronage dividends (and in the case of tax-exempt cooperatives other income distributed on a patronage basis) in cash if the cooperatives are to receive any deductions for allocations (and the patrons are to be required to include any such amounts in their income).

Under the House bill a patron could give his consent to being taxed on a noncash patronage dividend (as having been constructively paid to him and then reinvested) either by providing such consent in writing, or by being a member of the cooperative during the period in which its bylaws provided that membership constituted such consent. Your committee, in addition to these two procedures, has provided that consent may also be supplied by endorsing and cashing a qualified check. The check must indicate, however, that by endorsing and cashing it the patron is consenting to taking the remainder of the patronage dividend into account in computing his taxable income. This may be a convenient way of obtaining consent for some cooperatives, particularly from nonmembers, who it may be difficult for the cooperative to contact directly. For a cooperative to omit a patronage dividend under this procedure in computing its taxable income for the year the patronage occurs, the qualified check must be endorsed and cashed within 90 days after the end of the payment period for the cooperative, namely, within 90 days after 8½ months after the close of the cooperative's taxable year. A qualified check endorsed and cashed after that time will be deductible by the cooperative when the endorsing and cashing occurs, as a redemption at that time of a nonqualified allocation.

C. General explanation of provision

This provision deals both with the tax treatment of cooperatives and the tax treatment of patrons.

1. Cooperatives covered by provision.—The tax treatment outlined here applies to the so-called tax-exempt farmers' cooperatives, to other farm cooperatives, to consumer cooperatives, and also to other corporations operating on a cooperative basis. The provision does not, however, apply to exempt mutual ditch, irrigation, or REA cooperatives, to mutual savings banks, building and loan associations, etc., or to mutual insurance companies. It also does not apply to presently taxable organizations which are engaged in furnishing electric energy, or providing telephone service, to persons in rural areas. These will continue to be treated the same as under present law.

2. Patronage dividends.—The bill provides that in determining the taxable income of a cooperative there is not to be taken into account patronage dividends which are paid in money, qualified allocations, or other property (except nonqualified allocations).[1] A deduction also is allowed for nonqualified allocations when they are redeemed in cash or other property (except allocations). If there is no taxable income in the year of the redemption against which to take this deduction for redeemed nonqualified allocations, the cooperative may obtain a credit or refund of the tax it paid in the prior year on the earnings represented by the allocations. This gives the cooperative assurance that the deduction for the redeemed patronage dividend will not be wasted.

Under present law patronage dividends paid by taxable cooperatives result in a reduction in the cooperative's taxable income only if they are paid during the taxable year in which the patronage occurred, or within the period in the next year elapsing before the prior year's income tax return is required to be filed (including any extensions of time granted). This is generally a 2½-month period. In the case of exempt farmers' cooperatives, these patronage dividends presently are taken into account as a reduction in taxable income if paid at any time before the 15th day of the 9th month following the close of the year, but there is no requirement that the patronage must have occurred in that year. The bill extends the time period in

[1] For purposes of the internal revenue laws these patronage dividends are treated in the same manner as items of gross income for which deductions were allowed.

which taxable cooperatives can pay patronage dividends, and still take them into account in reducing taxable income, until this 15th day of the 9th month after the end of the year in question. This conforms the treatment to that already accorded exempt cooperatives. This period of time is also made available to both "taxable" and "exempt" cooperatives for payment of the other deductible amounts described below. In addition, exempt cooperatives are now required to pay the patronage dividends within 8½ months after the year when the patronage occurred. In the case of pooling arrangements extending over more than 1 year, the patronage is considered as occurring in the year in which the pool closes.

3. *Qualified allocation.*—Allocations, or more exactly written notices of allocation, must be in the form of capital stock, revolving fund certificates, certificates of indebtedness, or other written notice which indicates to the recipient the dollar amount allocated to him by the cooperative. For the allocation to be a qualified allocation, 20 percent of the patronage dividend involved must be paid in money (or in a "qualified check" referred to below).[2] In addition, for the allocation to be qualified one of two other conditions must be met. The patron must either have the opportunity to take down the allocation in cash for a limited period of time, or, in one of three specified forms, must have given his consent to having the allocation treated as constructively distributed to him and reinvested by him in the cooperative. With respect to the first of these requirements, the bill provides that the patron must be able to convert the allocation into cash at any time during at least the first 90 days after the allocation is made. In addition, the patron must receive a written notice of the right of redemption at the same time he is notified of the allocation.

In lieu of the right to convert an allocation into cash, an allocation may be qualified where the patron gives his consent to have it treated as a distribution made to him which he agrees to take into his income for tax purposes (if the patronage arises from business activity). Under your committee's amendments this consent may take any one of three forms. For members of the cooperative this consent may be given merely by becoming, or continuing, as a member after the cooperative has adopted (after the enactment of this bill) a provision in its bylaws providing that membership in the cooperative constitutes such consent. In this case, however, the member (or prospective member) must be furnished with a written notice that the bylaws contain such a provision and must be furnished a copy of this provision. Such a consent cannot be revoked as long as the patron is a member.

A second form of consent, which may be used either for members of the cooperative, nonmembers or both, is a written statement signed by the patron in which he gives the consent referred to above. This form of consent must originally be given by the patron to the cooperative before the end of the year in which the patronage occurs and applies to all patronage in that year and subsequent taxable years until the consent is revoked. A revocation of this consent must be in writing and can be made at any time but becomes effective only for the first of the next year.[3]

[2] The 20-percent cash payment is also required in the case of exempt cooperatives for amounts paid on a patronage basis with respect to earnings derived from business done for the United States (or any of its agencies) or from sources other than patronage.

[3] In the case of pooling arrangements, a revocation is effective only with respect to new pools.

A third form of consent, provided by your committee's amendments involves the use of a qualified check. This may apply either to members, nonmembers, or both, but applies only if neither of the other two forms of consent had been obtained with respect to a patron. Under this form of consent the cooperative gives the patron a check representing a portion of the patronage dividend.[4] This check (which also includes a similar instrument redeemable in money) must have clearly imprinted on it a statement that its endorsement and cashing constitutes consent of the patron to include the full stated dollar amount of the allocation, referred to in the check, in his income, to the extent provided by the Federal tax laws. To treat the noncash allocation accompanying the qualified check as a qualified allocation, the check itself must be cashed not later than 90 days after the payment date of the cooperative for patronage dividends (that is, 90 days after September 15 in the case of a calendar year cooperative). This is not intended to deny the cooperative the right, however, to issue the qualified checks substantially before the payment date and require cashing within a 90-day period thereafter. In this manner, if the cooperative wants to, it may require any cashing of the checks before its payment date.

By any of the three forms of consent described above the patron has in effect acknowledged constructive receipt of the entire amount of the patronage dividend and has voluntarily reinvested the amount of the allocation in the cooperative.

If an allocation is not a qualified allocation because one of the conditions set forth above has not been met, it must be included in the income of the cooperative in the year issued, with a deduction being taken for this amount by the cooperative only when the nonqualified allocation is finally redeemed in cash or merchandise. If at that time the cooperative is not able to make use of a deduction, a refund may be obtained with respect to the taxes paid on this amount in the year the allocation was issued.

4. Additional deduction for "exempt" farmers' cooperative.—In addition to reducing taxable income for qualifying patronage dividends, the bill, permits the so-called exempt farmers' cooperative, as under present law a deduction for amounts paid out as dividends on its capital stock. Such cooperatives also receive deductions for amounts paid in money, qualified allocations, or other property (except nonqualified allocations) to their patrons on a patronage basis where the earnings involved are derived from business done for or with the U.S. Government or from sources other than patronage (such as investment income).

This deduction is the same as that provided by existing law except that the deduction is limited to qualified allocations and must be paid within 8½ months after the year in which the earnings were *derived.* Amounts paid in the redemption of nonqualified allocations also are available to these exempt cooperatives as deductions under the bill in the year of the redemption.

5. Treatment of patron.—With the exceptions referred to below, under the bill the patron is required to take into income the patronage dividends (and the nonpatronage distributions described above) paid

[4] The check may also be used as part of a distribution of any amounts paid on a patronage basis with respect to earnings derived from business done with the United States (or any of its agencies) or from sources other than patronage.

in money, qualified allocations, or other property, and the amount he is required to take into his income is the same as that which may be currently deductible or excluded by the cooperative; namely, in the case of qualified allocations, there stated face amount, and in the case of other property (except nonqualified allocations) its fair market value. The patron also is required to take into income any nonqualified allocations which are redeemed. These amounts are taken into the patron's income in the year in which they are received by him, or in the latter case in the year in which the redemption occurs.

Generally, the effect of the treatment specified above for patrons taken together with that also outlined above for cooperatives is to obtain a single current tax with respect to the income of the cooperative, either at the level of the cooperative or at the level of the patron. However, this rule will not apply in the case of patronage dividends paid with respect to purchases of personal, living, or family items. with respect to the patronage dividends even though they are not In such cases there is to be no inclusion in the income of the patron taken into account by the cooperative. This is in accord with the concept that patronage dividends represent price adjustments. Therefore, the patronage dividends in these cases represent downward price adjustments of personal, living, or family items and should no more lead to taxable income than bargain purchases of such items elsewhere.

An exception to the rule for inclusion of the patronage dividends in income is also made for patronage dividends attributable to purchases of depreciable property or capital assets. In such cases the patron is not required to take the dividend into income since it in effect represents an adjustment in the price paid for these articles and therefore is reflected in their basis. However, the lower basis for the property in the case of depreciable property will mean smaller depreciation deductions or in the case of capital assets (and depreciable assets) will result in a larger gain upon sale.

6. *Returns of cooperatives.*—Because tax-exempt cooperatives under present law are given until 8½ months after the end of the year to allocate, or pay, patronage dividends, they also have been given the same period of time in which to file their tax returns. This additional time is necessary since whether or not there is an allocation or payment of the dividends, determines the size of the taxable income of the cooperative.

Allowing taxable cooperatives this same time in which to make cash and qualified allocations of patronage dividend distributions, and to redeem nonqualified allocations, has presented the same filing problem in the case of their returns as well. Therefore, the bill provides that the tax return filing date for cooperatives generally is to be 8½ months after the end of their taxable year. However, to prevent an organization allocating relatively little of its income on a patronage basis from obtaining this postponement in the filing date for its return, the bill limits this postponement to those organizations which are either exempt cooperatives or (1) are under an obligation to allocate, or pay, at least 50 percent of their net patronage earnings in patronage dividends or (2) actually allocated, or paid, at least that percentage of their earnings in patronage dividends during the last year in which they had any such earnings.

7. *Effective date.*—Generally, the bill applies to taxable years of the cooperatives beginning after December 31, 1962. For the patrons

these provisions are to apply with respect to amounts paid by the cooperative during a taxable year which, at the cooperative level, is also subject to the new rules. Existing law continues to apply with respect to patronage dividends paid before the date specified above (or after that date with respect to patronage in a prior year) and also with respect to redemptions of patronage dividends after that date if the scrip involved was actually issued with respect to an earlier period.

XVIII. INCLUSION OF FOREIGN REAL PROPERTY IN BASE FOR ESTATE TAX PURPOSES

(Sec. 18 of bill and secs. 2031, 2033–2038, 2040 and 2041 of the code)

A. Reasons for provision

Under present law real estate situated outside of the United States is excluded from the gross estate and therefore exempt from the estate tax. This is an exception to the general rule that the gross estate of decedents who are citizens or residents of the United States include their entire property wherever situated. The exclusion of real property located outside of the United States from the estate tax base has been specifically provided for in the code since 1934. Before that time the exclusion was granted under an opinion of the Attorney General issued in 1918.

In 1951 Congress adopted legislation providing a credit for estate and inheritance taxes paid to foreign countries. Before that time the exclusion of real property from the estate tax base could be justified on the grounds that the foreign country was likely to impose a tax on real property located within its jurisdiction upon the death of a foreign owner. However, with the provision for the tax credit in 1951, the possibility of double taxation was removed.

The President in his tax program recommended that this exemption be eliminated on the grounds that in recent years this has been a subject of abuse. It was stated that primarily because of this tax advantage, U.S. citizens and residents have been induced to make investments in foreign real estate in countries with either no, or very low, estate or inheritance tax rates.

In view of these considerations the House bill requires the inclusion of real property located outside of the United States in the estate tax base.

B. Comparison of committee amendments with House provision

Your committee has made no change in the House provision other than to advance by 1½ years the effective date of the provision. Thus, under your committee's action the provision will generally become effective for decedents dying on or after January 1, 1963, rather than July 1, 1964. As under the House bill the provision becomes effective for decedents dying after the date of enactment of the bill in the case of property acquired on or after February 1, 1962.

C. General explanation of provision

Under present law, real property situated outside the United States is excluded in determining the value of a decedent's gross estate for estate tax purposes. This section of the bill amends various sections of the code specifically to include such real property in the gross estate of decedents who are citizens or residents of the United States. The property is included at its fair market value either at the date of death or at the optional valuation date.

In the case of decedents dying after January 1, 1963, the bill provides that all real property located outside of the United States is to be included in the gross estate. However, some real property may also be included in a decedent's gross estate under the bill in the case of those who die after the date of enactment of the bill but before January 1, 1963. For decedents dying in this period, real property located outside of the United States is to be included in the gross estate if it was acquired on or after February 1, 1962, the date the House Committee on Ways and Means announced its action on this provision.

Capital additions or improvements to real property, to the extent they materially increase the value of the property and to the extent they are attributable to construction, reconstruction or erection on or after February 1, 1962, are treated in the same manner as real property acquired after that date. Thus, they are included in the gross estates of decedents dying after the date of enactment of the bill.

XIX. REPORTING OF INTEREST, DIVIDENDS AND PATRONAGE DIVIDENDS OF $10 OR MORE A YEAR

(Sec. 19 of the bill and secs. 6042, 6044, 6048, 6652 and 6678 of the code)

A. *Reasons for provision*

The House bill would have provided a 20-percent withholding tax applicable to most interest, dividend and patronage dividend payments. In recognition of the hardship that a universal withholding system would provide, the House bill provided for an annual exemption certificate system for individuals expecting to have no tax liability. In addition, it provided for quarterly refunds of overwithholding to be made to individuals expecting to have tax liability, but with incomes of less than $5,000 in the case of single persons or $10,000 in the case of married couples. The refunds in this case were intended to be made on a quarterly basis during the year in which the withholding occurred in order to relieve the hardship with respect to the individuals being overwithheld upon. In addition, under certain circumstances, exemption certificates, intra-annual refunds and credits and offsets would have been available under the House bill in the case of governments, tax-exempt organizations, or corporations.

Your committee has studied at length the system provided by the House bill for withholding on dividends, interest, and patronage dividends. In addition, it has considered numerous alternative withholding provisions. It is convinced after this analysis, however, that the provision in the House bill, as well as the alternatives, are neither simple in operation nor free of substantial hardship for broad groups of taxpayers. Furthermore, it represents a heavy administrative burden for the businesses which would have to perform the withholding and collecting functions for the Government. It also appears that there are numerous tax avoidance possibilities in a system providing exemption certificates and intra-annual refunds. The exemption certificate procedure under the House bill was available only to those who expected to have no tax liability whatsoever (unless the persons involved were under age 18). Thus, many individuals, who could expect to have a small tax liability, but be faced with substantial overwithholding on dividends and interest, would receive no relief under this exemption certificate system. Such individuals instead would have had to rely upon the quarterly refund system to recoup their overwithholding. Those who filed these claims could expect a delay of at least 3 or 4 weeks and perhaps as much as 3 or 4 months before the withheld amounts were returned. This would deprive them of the use of these funds for living expenses or as sources of investment during the interval. Moreover, the quarterly refund claims which would have had to be made four times a year involved a complex procedure.

While the exemption certificate and quarterly refund procedures of the House bill did not resolve the hardship problems for the shareholder or depositor, they nevertheless presented many compliance problems for the corporate and bank payors of the dividends and interest. Especially difficult from their standpoint would be the processing of the exemption certificates, which not only must be filed each year but also might be subject to change during the year as the individual's expectations with respect to his prospect of having a tax liability changed.

In addition, the House bill would have presented serious administrative problems for the Internal Revenue Service. The use of the exemption certificates, for example, in practice might not have been limited to those who "reasonably expect no tax liability." Moreover, since the individual, when he filed his quarterly refund claim, need submit no proof of the receipt of dividend or interest payments, here also there would seem to be a chance of fraud as well as unintentional mistakes. Nor is it clear that the ordinary recipients of dividends and interest would understand the so-called "gross-up" system which the House bill required them to follow in reporting dividends and most interest on their tax returns.

Despite the shortcomings of a system for withholding on dividends, interest, and patronage dividends, your committee strongly endorses the concept that everyone must pay his full share of the income tax liability. Moreover, it recognizes that the underreporting of dividends and interest on tax returns is a serious problem which needs correction. However, it has concluded that an improved reporting system is preferable to provision for withholding.

Your committee believes that the matching of information returns and tax returns by the Government can provide essentially the same check on dividend and interest reporting as a withholding system, except that the effectiveness of the information returns is not limited to collecting the tax at the first bracket rate. While it may be difficult initially to provide a full matching of information and tax returns, the extended use of automatic data processing, together with the accounting number system provided for in legislation enacted last year, should quite soon make it possible to provide for a full matching of these information and tax returns.

It is recognized that improving the collection of tax with respect to dividend, interest, and patronage dividend payments by an expanded use of information returns may involve some increase in the personnel of the Internal Revenue Service. It is believed, however, that this is preferable to the complications and hardships which would be involved under a withholding system.

As a result, your committee, in lieu of the withholding provisions of the House bill, provides that payors of dividends, interest, and patronage dividends are to report annually to the Federal Government all such payments aggregating $10 or more per person. In addition, they are to send the recipients of these dividends, interest payments, or patronage dividends an annual statement indicating the total of such payments.

B. Comparison of committee amendments with House provision

As indicated above, the House bill made provision for withholding at a rate of 20 percent with respect to most interest, dividend, and patronage dividend payments. In this system provision was made for the use of exemption certificates for individuals expecting to have no tax liability and a system of quarterly refunds for those having a tax liability but subject to overwithholding. Your committee's amendments in lieu of this provide for the submission by payors of information returns to the Government for interest, dividends, and patronage dividends of $10 or more per person per year. Essentially the same information must also be submitted by these payors to the recipients of interest, dividends, or patronage dividends. The reporting system provided is described more fully below.

C. General explanation of provision

1. Reporting requirements.—The bill provides that dividend, interest or patronage dividend payors who make payments during the year aggregating $10 or more to any person are to file annual returns with the Internal Revenue Service reporting such payments. (The term "payments" is intended to include not only actual payments in cash or its equivalent but also credits to the account of the payee which he may withdraw at any time without restriction.) The return must show the aggregate amount of the payments to the person involved and give the name and address of the person to whom the payments are made. The bill also provides that nominees, who receive payments of dividends or interest and make payments of $10 or more to other persons, also are to make a return to the Government with respect to annual payments of $10 or more per person. This category includes such payments as those made by stockbrokers to individuals where the stock is registered in the street name of the broker. In the case of patronage dividends, only cooperatives to which the new provisions of this bill apply (sec. 17) must file these returns with respect to patronage dividends.

Existing law in the case of dividend payments provides for the submission of information returns by every cooperation "when required by the Secretary or his delegate." Under regulations (sec. 1.6042-1) the Treasury Department has required information return reporting by those making dividend payments during the calendar year of $10 or more. In the case of interest payments, present law requires the submission of information returns with respect to payments of $600 or more, as is true in the case of numerous other types of payments made in the course of a trade or business. In addition, present law provides that payments of interest by corporations, regardless of amount, "when required by regulations of the Secretary or his delegate" must be reported to the Internal Revenue Service. In the case of interest, however, the Secretary has not by regulations provided for reporting with respect to payments of less than $600. In the case of patronage dividends, present law requires reporting to the Internal Revenue Service with respect to amounts of $100 or more. It also authorizes the Secretary to require reporting with respect to lesser amounts. The Secretary has not, however, exercised this authority.

Your committee's amendments, in addition to making mandatory the reporting of dividends, interest, and patronage dividends of more than $10 per year per person, also continue the provisions of present law permitting the Secretary at his discretion to require reporting with respect to smaller amounts.

In addition to the reporting to the Internal Revenue Service, your committee's amendments also require that annual statements be submitted to all recipients of dividend, interest, and patronage dividend payments of more than $10 a year. These statements must show the amount of the payment reported to the Government and the name and address of the payor. No such statements are required, however, to be furnished to any person if the aggregate of these dividend, interest, or patronage dividend payments is less than $10 a year.

2. Penalty provisions.—Your committee, in the interest of being sure that the information returns are supplied the Government, and also that the statements are submitted to the dividend, interest, or patronage dividend recipients, has provided civil penalties which apply in the case of noncompliance.

These new penalties apply with respect to the failure to supply the information statements to those receiving $10 or more a year and also to failures to supply information returns to the Internal Revenue Service with respect to dividend, interest, and patronage dividend payments of $10 or more a year per person. The penalty provided in these cases, for failing to provide either a statement to the recipient, or an information return to the Government, with respect to each person to whom $10 or more a year was paid, is $10 for each statement or return not so filed, but not to exceed $25,000 for failures to file returns with the Government and $25,000 for failures to submit statements to payees, with respect to the payor in any calendar year.

Existing penalties (in general $1 per statement but not more than $1,000 per payor) will continue to apply with respect to the reporting which the Secretary of the Treasury may require "for payments aggregating less than $10 a year."

3. Definitions.—In defining dividend, interest, and patronage dividend payments subject to the reporting requirements your committee has followed quite closely the definitions contained in the House bill for purposes of withholding.

Dividends are defined as distributions by a corporation which, for purposes of the Internal Revenue Code, generally are classified as a dividend. The definition of dividends for this purpose also includes payments made by stockbrokers to any person as a substitute for a dividend. This is primarily concerned with payments made by brokers to persons whose stock has been borrowed to cover short sales but who are due "dividend" payments.

Excluded from the definition of dividends for purposes of these reporting requirements are: (1) to the extent provided by regulations, any distribution or payment by a foreign corporation or to a foreign corporation, nonresident alien, or foreign partnership; and (2) undistributed taxable income of small business corporations electing to have their income taxed to their shareholders. In any case where a payor is unable to determine whether a payment is a dividend, he is to include the entire amount as a dividend for reporting purposes.

Interest for purposes of the reporting requirements is defined as—

(1) interest on evidences of indebtedness (such as bonds, debentures, notes, and certificates) issued by a corporation in registered form. In addition, to the extent provided in regulations, interest on other evidences of indebtedness issued by a corporation of a type offered by corporations to the public;

(2) interest on bank accounts;

(3) interest, or other amounts, paid by mutual savings banks, savings and loan associations, or similar organizations with respect to deposits or similar funds left with such institutions;

(4) interest on amounts held by insurance companies under an agreement to pay interest; and

(5) interest on deposits with stockbrokers and dealers in securities.

For reporting purposes the term "interest" does not include (1) interest on tax-exempt State and local government obligations, (2) to the extent provided by regulations, interest paid by or to foreign corporations, nonresident aliens, or foreign partnerships, and (3) interest on tax-free covenant bonds. These categories for which reporting in the case of interest payments is required to include practically no interest payments by individuals.

In the case of patronage dividends, reporting is to apply to patronage dividends paid in money, qualified allocations or other property except nonqualified allocations, amounts paid by tax-exempt cooperatives with respect to earnings from business done with the U.S. Government or attributable to other than patronage and nonqualified allocations which are redeemed.

The exceptions where the reporting does not apply in the case of patronage dividends include, to the extent provided by regulations, payments made by a foreign corporation, to a foreign corporation, to a nonresident alien or to a foreign partnership. In addition if a cooperative applies to the Secretary or his delegate for exemption from the reporting requirement on the grounds that the cooperative is primarily engaged in selling at retail goods or services of a type generally for personal, living or family use, and the Secretary determines this is true, no reporting shall be required with respect to such cooperative.

4. Inspection of books.—Present law (sec. 7605(b)) provides certain procedures which must be followed if the Internal Revenue Service needs to make an additional inspection of a taxpayer's books of account after it has once done so. Under this section, the Secretary or his delegate may not make an additional inspection before (1) an investigation which shows necessity for the additional inspection and (2) notification of the taxpayer in writing that the inspection is necessary. At present there are relatively few cases where it is necessary for the Service to reopen a taxpayer's return which has been audited. However, with the expanded information reporting provided by your committee, it is expected that the Service will follow up discrepancies each year with respect to many taxpayers. There are difficulties in coordinating these inquiries as to discrepancies disclosed by information returns with general audits of tax returns selected for examination. Such inquiries will be made as a routine follow-up of machine operations, and in most instances will be carried out independently of regular audit procedures.

Your committee wishes to make it clear that an Internal Revenue Service contact with a taxpayer solely for the purpose of verifying the correct amount of interest, dividends, and patronage dividends to be reported in cases of discrepancy between information returns and a tax return should not be considered as an inspection of a taxpayer's books of account (within the meaning of sec. 7605(b)). Thus, such an inquiry will not require an investigation and notification to the taxpayer in cases in which a prior audit has been conducted, nor will a subsequent audit require the investigation and notification merely because there has previously been an inquiry limited to determining the correct reporting by the taxpayer of items of gross income subject to reporting on information returns by the payors thereof.

XX. INFORMATION WITH RESPECT TO FOREIGN ORGANIZATIONS

(Sec. 20 of the bill and secs. 6038, 6046, and 6678 of the code)

A. Reasons for provision

The administration has asked for the right to obtain more information with respect to operations of Americans abroad. First, with respect to the annual information return, now required of domestic corporations controlling foreign corporations, it was requested that this return also be required of individual citizens or residents of the United States controlling foreign corporations. Second, in addition to the various specified types of information now required to be submitted, it was also requested that the Treasury Department be permitted to require the furnishing of other information which is similar or related in nature to that specified in the existing provision. Third, existing law requires the supplying of this information with respect to a foreign subsidiary, or a subsidiary of such a subsidiary. It was desired that this information also be required of any other controlled foreign corporation. Fourth, it was requested that the definition of "control" be broadened to include most of the constructive ownership rules generally applied elsewhere in the code.

The administration also requested that the information return now required of officers, directors, and significant shareholders of foreign corporations upon the creation, organization, or reorganization of such corporations also be required of persons who are now, or when they become, officers, directors, or important shareholders.

In addition, the administration requested that a civil penalty be provided for those failing to file the returns as to organization, reorganization, etc., of foreign corporations. The penalty in this case is to be $1,000 unless it can be shown that the failure is due to reasonable cause.

The House bill provided for the submission of this additional information.

B. Comparison of committee amendments with House provision

Your committee has accepted the House provision for expansion of the information to be required with respect to foreign organizations, with four modifications. Two of these relate to the annual information return. First, with respect to the annual information return it has provided a "ceiling" on the penalty which may be imposed in those cases where this information is not supplied. The penalty under present law in general terms provides that failure to supply the required information will result in a decrease of 10 percent in the foreign tax credit allowed to a domestic corporation, plus an additional 5 percent for each additional 3-month period during which the failure to furnish the information continues. Your committee's amendments provide that in no event shall this penalty exceed $10,000 or the income of the foreign corporation with respect to which the failure occurred, whichever is the greater. Second, in the case of the annual information return, in determining whether or not 50-percent control exists, your committee has narrowed somewhat the constructive ownership rules applied under the House bill.

In the case of the information required with respect to organizations, reorganizations, etc., your committee also has made two amendments. First, it provided that officers or directors who are U.S. citizens need supply information only if there are 5-percent U.S. shareholders, and that the information they submit be only the names and addresses of such shareholders. Second, it has added a provision that no information is to be required to be furnished with respect to a foreign corporation unless that information was required under regulations in effect 90 days prior (30 days prior at the beginning of the first year) to the date on which the U.S. persons become liable to file the return with respect to the information.

C. General explanation of provision

1. Annual information return.—In 1960 Congress enacted legislation (Public Law 86–780) providing that domestic corporations must furnish with respect to foreign corporations which they control and also with respect to foreign subsidiaries of any such foreign corporations information specifying—

(1) The name, place, and nature of business of the foreign corporation and country of incorporation;

(2) The accumulated profits of the foreign corporation or subsidiary, including items of income, deduction, and other items taken into account in computing these accumulated profits;

(3) A balance sheet of the foreign corporation or foreign subsidiary;

(4) Transactions between the foreign corporation or foreign subsidiary and (*a*) other foreign corporations or foreign subsidiaries controlled by the domestic corporation, (*b*) the domestic corporation or (*c*) any shareholder owning at least 10 percent of the stock of the domestic corporation; and

(5) A description of the various classes of stock outstanding and name and address and number of shares held by each citizen or resident of the United States and domestic corporation holding 5 percent or more of the stock of the foreign corporation or foreign subsidiary.

Corporations failing to supply any of the information required on the due date receive a 10-percent reduction in their foreign tax credit otherwise available with respect to the income derived from all the foreign corporations or their subsidiaries. If the failure to supply the information continues for more than 90 days, after notification of this failure, then for each 3 months of additional time (or fraction) the reduction in the credit is increased by 5 percent.

The House bill amends this information provision in several respects. First, it requires U.S. citizens or residents, domestic partnerships and domestic estates or trusts as well as domestic corporations controlling the foreign corporations to supply the information specified. Second, "control" is redefined by adding most of the constructive ownership rules of the existing section 318(a). Third, the House bill also extends somewhat the type of foreign corporation with respect to which information must be supplied. Existing law applied to foreign corporations controlled by Americans and subsidiaries which they control. In other words, it applies to two levels of ownership of foreign corporations. The bill extends the requirement to apply to any number of levels of ownership so long as there is control of the corporations involved. Fourth, in addition to the listed types of information, the Treasury Department may also require the furnishing of any other information which is similar or related in nature to that specified.

Your committee has accepted the House amendments with a modification of the constructive ownership rules referred to above and with the addition of a "ceiling" on the penalty provided by present law for the failure to supply the information required. In the case of the constructive ownership rules it has provided that stock owned by a partner, an estate, a trust, or a corporation will not be treated as being owned by the partnership, estate, trust or corporation if this treats a U.S. person as owning stock owned by a person who actually is not a U.S. person. Your committee's amendments also provide that a person is not to be considered as owning his pro rata share of stock held by a corporation if his stock interest is not more than 10 percent.

As indicated above, if a domestic corporation fails to supply information with respect to a subsidiary, it may lose anywhere from 10 to 100 percent of its foreign tax credit, even though only a small proportion, or none, of this credit may be attributable to the subsidiary with respect to which the information is not supplied. Your committee's amendments limit the credit which may be denied in such a case to $10,000 or the amount of income of the foreign subsidiary with respect to which the failure occurs, whichever is the greater.

2. Information with respect to organization, reorganization, etc.—Present law also requires U.S. citizens or residents who are officers or directors of a foreign corporation within 60 days of its creation, organization or reorganization, and also U.S. persons who within the same 60-day period own 5 percent or more of the value of the stock of the corporation, to supply information with respect to this corporation. The return is required to contain such information as the Secretary of the Treasury or his delegate prescribes by forms or regulation as necessary to carry out the provisions of the income tax laws.

Under existing law it is possible to avoid this information requirement where the U.S. citizen or resident first becomes an officer, director, or owner of 5 percent or more of the value of the stock of the corporation after the 60-day period. To prevent this avoidance of the information requirement the bill extends the requirement for supplying the information so that it applies to those U.S. citizens or residents who are officers, directors, or shareholders with more than a 5-percent interest on January 1, 1963, or who acquire such positions after that date. This information also is to be supplied by shareholders whose holdings after that date are increased to 5 percent (or where they acquire an additional 5 percent of the stock of the corporation). This reporting requirement in the case of U.S. citizens or residents who are officers or directors, however, under your committee's amendments applies only if there is a U.S. person who holds 5 percent or more of the stock of the corporation. Moreover, only the names and addresses of the 5-percent shareholders who are U.S. persons are required to be reported.

Your committee has also added an amendment to provide that no information is to be required of a foreign corporation unless that information was required under regulations in effect 90 days (30 days at the beginning of first year) prior to the time the liability to file a return under this provision arises.

The bill also adds a new section to the code providing a civil penalty in the case of any person required to file the return referred to here who fails to do so at the time required, or who files a return which does not show the information required. The penalty in this case is to be $1,000 unless it is shown that the failure is due to reasonable cause.

3. *Effective dates.*—The amendments with respect to the annual information return apply with respect to annual accounting periods of the foreign corporations beginning after December 31, 1962. The amendments relating to the filing of returns as to organization, reorganization, etc., of foreign corporations takes effect on January 1, 1963.

XXI. CLEARING OF LAND

(Sec. 21 of the bill and sec. 182 of the code)

A. *Reasons for provision*

Under existing law expenses incurred in carrying on a trade or business of farming are deductible in determining taxable income. In 1954 Congress amended the statute to include in the deductible category expenses for soil and water conservation.

This new provision deals with a problem quite similar to that which resulted in the enactment of the soil and water conservation provision. At the present time, expenditures made during the preparatory period in extending a farm may not be deducted since they are not expenses incurred in the business of farming. Examples of expenditures of this nature which, under existing law, must be capitalized are expenditures (including material and labor) incurred in: (1) Clearing brush, trees, and stumps, (2) leveling and conditioning land, and (3) straightening creek beds. Because expenditures for these purposes, when incurred in order to make the land suitable for farming (like expenses for soil conservation), also are closely associated with the trade or business of farming, your committee believes that it would be proper to allow their deduction to a limited extent.

B. Comparison of committee amendment with House provision

There was no comparable provision in the House bill.

C. General explanation of provision

This provision permits taxpayers engaged in the business of farming to deduct, in computing their Federal income tax, expenditures incurred by them in clearing land to make it suitable for farming. Activities included in clearing and preparing land to make it suitable for farming include the clearing of brush, trees, stumps, and boulders, the leveling and conditioning of the land, and the diversion of streams.

Under the bill, deduction of expenditures in any taxable year for these purposes may not exceed $5,000, or, if lesser, 25 percent of the taxpayer's taxable income from farming. In determining the amount which may be deducted within these limitations, the farmer is permitted to include a reasonable allowance for depreciation with respect to tractors and other items subject to the allowance for depreciation which are ordinarily used by him in his farming activities but which actually may have been used also in the clearing of land.

This provision is to apply for taxable years beginning after December 31, 1962.

XXII. CHARITABLE CONTRIBUTIONS MADE FROM INCOME ATTRIBUTABLE TO SEVERAL TAXABLE YEARS

(Sec. 22 of the bill and sec. 1307 of code)

A. Reasons for provision

In the case of individuals who receive compensation in 1 year for services performed over a period of more than 3 years, or who receive a lump sum of income from an invention or artistic work (or from certain other specified sources) present law provides that the tax on this income is not to be greater than the tax which would have resulted if the bunched income had been received ratably over the period to which it is attributable. The effect of this is to permit income to be averaged for tax purposes in the specified situations.

In applying this provision, the Internal Revenue Service has ruled that deductions based upon adjusted gross income (such as charitable contributions and medical expenses) must be recomputed each time a different amount is taken to represent adjusted gross income in determining tax under the averaging provisions (IR–Mim. 43, 1952–2CB 112). It has come to the attention of your committee that because of this recomputation some individuals who make substantial charitable contributions in years in which they receive "bunched income" are unable to take full advantage of the deduction for such contributions. This occurs because, although the bunched income in effect may be spread over the years to which it is attributable, contributions may be deducted only in the year in which they are made. Thus, while the charitable contribution may have been fully deductible if the individual's adjusted gross income for the year were determined before the spreading, once the spreading provisions are applied adjusted gross income for the year in which the contribution is made must be reduced, thereby limiting the amount of the charitable contribution which may be deducted.

To prevent this wastage of charitable contribution deductions your committee has added to the House bill a provision which permits the individual an election to apply the charitable contribution limitations to the adjusted gross income before the bunched income in effect is spread over the years to which it is attributable.

B. Comparison of committee amendments with House provision

There is no comparable provision in the House bill.

C. General explanation of provision

This provision adds to the statute a special rule for determining the amount of charitable contributions deductible by an individual when his "bunched income" is to be spread under the special "averaging" provisions of the tax law. Under this rule the limitation on charitable contributions (20 or 30 percent of adjusted gross income) made in the year in which the bunched income is received may be applied before the income is spread over the years to which it is attributable. Only the net amount of bunched income remaining after the charitable contribution has been deducted will in effect be spread back over the years to which attributable. If the individual elects to deduct charitable contributions in this manner, he cannot include again any portion of the bunched income in determining the limitation on charitable contributions for the year in which the bunched income is received after the income is spread over the years to which it is attributable.

This provision is to apply with respect to taxable years beginning after December 31, 1962.

XXIII. EFFECTIVE DATE OF SECTION 1371(c) OF THE INTERNAL REVENUE CODE OF 1954

(Sec. 23 of bill and sec. 1371(c) of code)

A. Reasons for provision

Under existing law certain small business corporations may elect to have income taxed directly to their shareholders, thereby eliminating tax at the corporate level. For such an election to be valid, however, the corporation must have no more than 10 shareholders and each shareholder must give his consent to the election.

Previously a problem existed as to the proper method of determining the number of shareholders of a corporation in community property States or where the stock of a corporation was held jointly by husband and wife. In 1959 Congress removed this problem by specifically providing how the number of shareholders was to be determined where husband and wife resided in community property States or where they held stock jointly. Congress provided in such cases that the spouses would be treated as one shareholder (Public Law 86-376, approved September 23, 1959). This provision was made effective with respect to taxable years of small business corporations beginning after December 31, 1959. However, cases have come to the attention of your committee in which small business corporations were prevented from making (or continuing) an election to have their income of 1958 and 1959 taxed to their shareholders because husbands and wives in community property States or who held stock jointly have each been counted as a separate shareholder for those years. The first year with respect to which such an election could be made was 1958.

Your committee does not believe that the rule enacted by Public Law 86-376 for determining the number of shareholders of a small business corporation should be limited to years after 1959, but should apply to all years for which such an election may be made. This will insure the application of the same rules in applying the 10-shareholder limitation for all years in qualifying a small business corporation for such an election. Accordingly, this provision of the bill makes that rule of Public Law 86-376 apply also to years 1958 and 1959.

B. Comparison of committee amendments with House provision

There is no comparable provision in the House bill.

C. General explanation of provision

This bill provides that with respect to the years 1958 and 1959, in determining the number of shareholders of a small business corporation for purposes of the election provided by subchapter S of the Internal Revenue Code (under which shareholders are taxed directly on the corporate earnings), spouses who hold stock of such a corporation jointly or under the community property laws of a State are to be treated as one shareholder; that is, section 1371(c) of the code will now be applicable to such years.

In order to insure that a small business corporation whose status may be affected by this provision will have an opportunity to qualify for treatment under subchapter S, the bill provides a special 1-year period within which a special election may be made to have the earlier effective date of section 1371(c) apply. For the special election to be valid, however, a corporation must have met the statutory requirements of subchapter S in 1958 and 1959, and must have filed a timely election to be subject to subchapter S for those years. Furthermore, each person who is a shareholder at the time of the special election must give his consent and each person who was a shareholder for any taxable year ending before the year in which the special election is made also must give his consent. Finally, where an election (and the requisite consents) has been made, the statute of limitations for assessing additional tax against the corporation or its shareholders is to remain open, or be opened, for 1 year following the date of the election. Tax assessed or credit or refunds granted within this special period of limitations must relate only to changes resulting directly from the election.

XXIV. CERTAIN LOSSES SUSTAINED IN CONVERTING FROM STREET RAILWAY TO BUS OPERATIONS

(Sec. 24 of the bill)

A. Reasons for provision

Present law provides that business losses incurred in one year can be carried back to the 3 prior years and then, to the extent not absorbed by income in those years, carried forward to the 5 succeeding years after the year in which the losses occurred. For most companies which again earn income such a period is long enough to absorb all of their losses against income.

Rapid transit companies in recent years have had a special problem in connection with the very large losses they have incurred in converting from streetcar to bus operations. Because of the size of these losses, most transit companies have spread their conversion to buses over many years—some over as many as 15 years—so that a sufficient period will be available to absorb the losses against income. However, a situation has come to the attention of your committee in which the conversion from streetcars to buses was completed in an 18-month period. It appears that the conversion was made in such a short period because of fraud on the part of the then existing management. Moreover, evidence is available that the then existing management made this conversion in the 18-month period despite the fact that it was pointed out to them by their financial experts that such losses could not be absorbed within the period of the 5-year carryforward.

After the mismanagement was discovered, the company was reorganized and new officers and a new board of directors elected. However, the conversion from streetcars to buses in the 18-month period could not be undone. As a result of this conversion the company sustained a loss of approximately $10,200,000. At the end of the 5-year carryforward period about $5,200,000 of this loss remained unused. While the company has recently been making a small profit, it appears that rate increases may have to be requested if this remaining loss cannot be offset against the income of future years.

Your committee believes that since ordinary prudent, honest management would have spread the conversion over a number of years, a longer carryforward of the unused loss should be permitted. This is a particularly serious problem because of the present inadequacy of ~~our~~ mass transportation system and the fact that a rapid transit system is involved here. Moreover, in this case it is likely that in the long run it will be the users of the transportation who will suffer if the company is not permitted to utilize the benefit of this loss.

B. Comparison of committee amendments with House provision.

There was no comparable provision in the House bill.

C. General explanation of provision

The bill provides that in the case of net operating losses incurred in the calendar years 1953 and 1954, principally as a result of the conversion from streetcar to bus operations, an additional 5 years is to be allowed to offset such losses against income. The bill achieves this result by providing that such losses are to be known as "unused conversion losses" to the extent they still remain unused after the end of the normal 5-year carryforward period. The bill provides that such an unused conversion loss from these 2 years is to be considered a net operating loss sustained in 1959 and therefore available as a net operating loss carryforward to the calendar year 1960 and four subsequent taxable years.

The treatment described above is to apply only for years in which the taxpayer is engaged in the furnishing or sale of transportation on a local electric railroad, trackless trolley system, or bus system. The rates for the transportation in such cases must have been established or approved by a governmental unit, by a public service or public utility commission or similar body.

In the case brought to your committee's attention there is an unused loss of approximately $5,200,000 from the years 1953 and 1954, and it is estimated, based upon anticipated revenues, that from $2 to $3 million of this loss can be offset against income in the additional 5-year period allowed by this bill.

XXV. PENSION PLAN OF LOCAL UNION NO. 435, INTERNATIONAL HOD CARRIERS' BUILDING AND COMMON LABORERS' UNION OF AMERICA

(Sec. 25 of the bill)

A. Reasons for the provision

Under present law, a pension trust is qualified for income tax exemption only if it meets certain requirements relating to coverage of employees and nondiscrimination of contributions or benefits. Where the pension trust is properly qualified, not only is it exempt from Federal taxation with respect to its income, but contributions paid to it by an employer on behalf of his employees are deductible for Federal income tax purposes. Thus, there is considerable incentive for a pension trust to meet the requirements of the Internal Revenue Code and thereby become a qualified trust.

Occasionally, however, it is difficult for a pension trust to achieve qualified status before employer contributions are received by it. This is particularly true in the case of pension plans negotiated under collective-bargaining agreements with many employers, both large and small. Often, considerable time is required to obtain sufficient factual data upon which to insure the actuarial soundness of the plan. Sometimes a formality is not properly performed.

In such cases, where the pension plan operates for some period as a nonqualified plan prior to securing qualification under the Internal Revenue Code, any income it may earn during such period is subject to income tax, thereby reducing amounts which would otherwise serve to provide employee benefits under the plan. In addition, employer contributions are not allowed as deductions unless the employee is given immediate vested rights to the contribution.

Your committee believes these are rather severe consequences, particularly where failure to meet the conditions of the statute for qualification is due to the fact that, because the plan involved many employers, the arrangements could not be worked quickly although it was the initial intention of both the employers and the unions to meet those conditions. If the pension trust has never been operated in a manner which would jeopardize the interest of its beneficiaries, and if, when completed, the pension plan of which the trust is a part conforms with the Internal Revenue Code and has received the approval of the Internal Revenue Service, your committee believes it is just, under such circumstances, to provide that the pension plan be treated as a qualified trust during the intervening period between its inception and the time it actually qualified for tax exemption.

B. Comparison of committee amendments with House provision

There is no comparable provision in the House bill.

C. General explanation of provision

This section of the bill provides that the pension plan of Local Union No. 435, International Hod Carriers' Building and Common Laborers' Union of America, established pursuant to negotiations between the union and the Building Trades Employers' Association of Rochester, which is a qualified trust under section 401(a) of the Internal Revenue Code, is to be treated as having been a qualified trust and to have been exempt from taxation for the period beginning May 1, 1960, and ending April 20, 1961. For this provision to apply however, it must be shown to the satisfaction of the Secretary of the Treasury or his delegate that the trust has not in the period designated been operated in a manner which would jeopardize the interests of its beneficiaries.

Under the bill not only will the income of the pension plan during the specified period be exempt from tax but also contributions made under the plan within such period by employers generally will be deductible by them in determining their Federal income tax liability.

XXVI. CONTINUATION OF PARTNERSHIP YEAR FOR SURVIVING PARTNER IN A TWO-MAN PARTNERSHIP WHERE ONE DIES

(Sec. 26 of bill and sec. 188 of 1939 code)

A. Reasons for provision

The attention of your committee has been called to a case where the partnership provisions of the 1939 Code worked a substantial hardship. The case brought to your committee's attention involves a two-man partnership with a partnership year ending on January 31. The 1939 Code provides that income of partnerships is to be reported by the partners for tax purposes in their year in which, or with which, the partnership year ends. Thus, income from the partnership year ending on January 31, 1946, for example, would be reported by partners on a calendar year basis in their calendar year 1946. However, where one of the partners dies, for example, before the end of December, 1946, the partnership income in that year, which ordinarily would be reported for tax purposes by the partners in 1947, must then be reported by the partners, or their estate, in the calendar year 1946. This can result in a bunching of income, and therefore application of the higher surtax rates, since income of a partner for as long as 23 months may, in this manner, have to be reported in a single year.

At the time of the passage of the 1954 Code, the law was changed to provide that the partnership year was not to close upon the death of a partner but instead was to run to its normal conclusion. In this regard the report of your committee on the 1954 Code stated as follows:

> Under present law there has been the contention that the death of a partner closes the partnership year and [in] the bunching of more than a year's income in the decedent's last year. Where the partnership and the partners are on different taxable years, this would have the effect of concentrating as much as 23 months' income in the final return of the deceased partner, that is, the income for the partner-

ship year ending within his taxable year and the income for the taxable year closed by the partner's death.

The problem presented in the case called to your committee's attention occurred before the 1954 Code provision became applicable. Moreover, here the bunching occurs not only with respect to the deceased partner, but with respect to the surviving partner as well, since a partnership was held to no longer exist upon the death of one of two partners.

B. Comparison of committee amendments with House provision

There is no comparable provision in the House bill.

C. General explanation of provision

The bill adds a provision to the 1939 Internal Revenue Code to provide that the death of a partner in a two-man partnership is not to result in the termination of the partnership, or the closing of the taxable year of the partnership with respect to the surviving partner, prior to the time the partnership year would have closed if neither partner had died nor disposed of his interest. Thus, in the case of a partner dying in 1946 where the partnership year does not end until January 31, 1947, the partnership year would continue to that date and the income for such year would be reported by the surviving partner on his tax return for 1947. This provision is to apply only if the surviving partner so elects within 1 year after the date of enactment of this provision.

This amendment applies to taxable years of a partnership beginning after December 31, 1946, to which the Internal Revenue Code of 1939 applies. Generally the 1939 Code applied to partnership taxable year beginning before January 1, 1955. The bill also provides that if refund or credit for an overpayment resulting from the application of this provision is prevented by the operation of any law or rule of law (other than those relating to closing agreements or compromises) the refund or credit of the overpayment may nevertheless be made if the claim is filed within 1 year after the date of enactment of this bill.

XXVII. TREATIES

(Sec. 27 of bill)

Section 7852(d) of the code provides that no provision of the internal revenue title is to apply where its application would be contrary to any treaty obligation of the United States in effect on the date of the enactment of the Internal Revenue Code.

The House bill provided that section 7852(d) of the code was not to apply to any provision contained in this bill and that if any provision in this bill would contravene any existing tax treaty, then the new statutory law was to have precedence over the prior treaty obligation.

Numerous witnesses before your committee have expressed the view that provisions in the bill would be contrary to tax treaty obligations of the United States. Your committee has no desire to abrogate any provision in any treaty. For that reason, it has substituted for the provision in the House bill, language which provides that no provision of this bill is to apply in any case where its application would be contrary to any treaty obligation of the United States. The Secretary of the Treasury in his appearance before your committee has indicated that he is in agreement with the adding of this provision.

XXVIII. NEW ELECTION TO FILE SEPARATE RETURNS WHERE CONSOLIDATED RETURN HAD BEEN FILED

The Internal Revenue Code leaves to regulations issued by the Treasury Department requirements as to the filing of consolidated returns by an affiliated group and the requirements for changing from a consolidated return to separate returns. Generally it has been held that a consolidated return once filed must be continued in subsequent years unless there is a significant change in the tax laws. Your committee agrees with the House that enactment of this bill constitutes a significant change in the tax laws and that a new election to file separate returns where a consolidated return has previously been filed should be available for the first taxable year ending after the date of enactment of this bill.

TECHNICAL EXPLANATION OF THE BILL

TABLE OF CONTENTS OF TECHNICAL EXPLANATION OF THE BILL

TECHNICAL EXPLANATION OF THE BILL

SECTION 1. SHORT TITLE, ETC.

(a) *Short title.*—Section 1(a) of the bill provides that the bill may be cited as the "Revenue Act of 1962."

(b) *Table of contents.*—Section 1(b) of the bill consists of a table of contents for the bill.

(c) *Amendment of 1954 Code.*—Section 1(c) of the bill provides that, except as otherwise expressly provided, whenever in the bill an amendment or repeal is expressed in terms of an amendment to (or repeal of) a section or other provision, the reference is to be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SECTION 2. CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

(a) *Allowance of credit.*—Section 2(a) of the bill redesignates section 38 of the code as section 39 and inserts a new section 38 in part IV of subchapter A of chapter 1 (relating to credits against tax).

Subsection (a) of the new section 38 provides that there is to be allowed, as a credit against the tax imposed by chapter 1 of the code, the amount determined under the new subpart B, added by section 2(b) of the bill. Subsection (b) of the new section 38 requires the Secretary of the Treasury or his delegate to prescribe such regulations as may be necessary to carry out the purposes of the new section 38 and the new subpart B.

(b) *Rules for computing credit.*—Section 2(b) of the bill adds a new subpart B to part IV of subchapter A of chapter 1 of the code. The new subpart consists of three sections (secs. 46–48) which are explained below.

SECTION 46. AMOUNT OF CREDIT

(a) *Determination of amount.*—Paragraph (1) of section 46(a) provides in general that the credit allowed for the taxable year is to be an amount equal to 7 percent of the qualified investment as defined in subsection (c) of section 46. Under paragraph (2) of section 46(a) the amount of the credit may not exceed so much of the liability for tax for the taxable year as does not exceed $25,000 plus 25 percent of so much of such liability as exceeds $25,000. However, the $25,000 amount provided by section 46(a)(2) is reduced in the case of certain married individuals filing separate returns (see sec. 46(a)(4)), corporations which are members of affiliated groups (see sec. 46(a)(5)), trusts and estates (see sec. 48(f)(3)), and certain other special types of taxpayers referred to in section 46(d).

Under paragraph (3) of section 46(a), the liability for tax for the taxable year is defined as the tax imposed by chapter 1 (including the 2-percent tax on consolidated taxable income) reduced by the sum of the credits against the income tax allowed by sections 33, 34, 35, and 37. For purposes of determining the liability for tax, the taxes imposed by sections 531 and 541 (relating, respectively, to the accumulated earnings tax and the personal holding company tax) are not considered taxes imposed by chapter 1. Thus, the liability for tax as defined in section 46(a)(3) and the credit allowable for the taxable year under section 38 are determined before computing any tax imposed by section 531 or 541.

Paragraph (4) of section 46(a) provides generally that, in the case of separate returns filed by a husband and wife, the credit allowed to each may not exceed so much of the liability for tax for the taxable year as does not exceed $12,500 plus 25 percent of so much of such liability as exceeds $12,500. However, this reduction in the limitation applies only if the taxpayer's spouse is entitled to an investment credit for the taxable year of such spouse which ends with, or within, the taxpayer's taxable year. Such spouse may be entitled to an investment credit either because of qualified investment made in such taxable year for (whether directly made or whether allocated to such spouse by, for example, a subch. S corporation or a partnership), or because of an unused credit carryback or carryover to, such taxable year.

Paragraph (5) of section 46(a) provides generally that the $25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) is to be reduced for each corporation which is a member of an affiliated group by apportioning $25,000 among the members of such group in the manner prescribed by regulations of the Secretary of the Treasury or his delegate. An affiliated group within the meaning of section 46(a)(5) is one described in section 1504(a), except that any corporation may be treated as a member of an affiliated group. Thus, an affiliated group for purposes of section 46(a)(5) may include any of the corporations excluded by section 1504(b) from being a member of an affiliated group for purposes of filing a consolidated return. For example, an affiliated group within the meaning of section 46(a)(5) could include a corporation exempt from taxation under section 501 or a foreign corporation.

The application of the limitation provisions of section 46(a) may be illustrated by the following example:

The qualified investment of an unmarried taxpayer is $2,050,000. His liability for tax for the taxable year is $185,000. The credit computed without regard to the limitation in section 46(a)(2) is $143,500 (7 percent of $2,050,000). The allowable credit for the taxable year is $65,000 ($25,000 plus 25 percent of $160,000).

(b) *Carryback and carryover of unused credits.*—Section 46(b) as passed by the House provided a 5-year carryover for unused credits. Your committee has added a 3-year carryback for unused credits.

Paragraph (1) of section 46(b) provides for a 3-year carryback and a 5-year carryover of any unused credit. Under this provision, if the credit earned during the taxable year exceeds the limitation under section 46(a)(2) for that year (hereinafter referred to as "unused credit year"), the excess (the credit earned but not used to reduce tax for that year) is a carryback to each of the 3 preceding taxable years, and a carryover to each of the 5 succeeding taxable years and, subject to the limitation of paragraph (2) of section 46(b), is to be added to the amount allowable as an investment credit for those years. Such excess, however, may be a carryback only to taxable years ending after June 30, 1962. The entire amount of the excess (the unused credit for any unused credit year) must be carried first to the earliest of the 8 taxable years to which section 46(b) permits it to be carried. It may then be carried to each of the other 7 taxable years (in order of time) to the extent that, because of the limitation provided in paragraph (2) of section 46(b), it could not be added for a prior taxable year.

Paragraph (2) of section 46(b) provides that the amount of the unused credit from an unused credit year that may be added to the amount allowable as an investment credit for any of the 3 preceding or 5 succeeding taxable years is not to exceed the amount by which the limitation (determined under sec. 46(a)(2)) for such preceding or succeeding taxable year exceeds the sum of (1) the investment credit allowable for such year by reason of investment made in such year, and (2) other allowable unused credits which are attributable to years prior to the taxable year in which the unused credit originated. Thus, before an investment credit carryback or carryover from an unused credit year may be taken into account in any preceding or succeeding taxable year, the credit allowable for such preceding or succeeding taxable year (determined without regard to carrybacks or carryovers of unused credits to that year) will first be applied. Unused credits originating from taxable years prior to the unused credit year will be applied next. To the extent that the investment credit carryback or carryover from an unused credit year cannot be used in a particular preceding or succeeding taxable year because the sum of the credit earned and allowable in that year and the carrybacks and carryovers to that year from taxable years preceding the unused credit year exceed the limitation on allowable credit for such year, the carryback or carryover will be carried forward to the next succeeding taxable year.

Effect of net operating loss carryback

Paragraph (3) of section 46(b) provides that to the extent that an unused credit arises by reason of a net operating loss carryback, subparagraph (A) of section 46(b)(1) will not apply. Although no investment credit carryback of an unused credit will be allowed to the extent that the unused credit arises from the application of a net operating loss carryback, the full amount of the unused credit so arising will be available for use as an investment credit carryover. Thus, assume a taxpayer's credit based on investments in 1965 is $25,000, and such credit is allowable in full for that year. Subsequently, such taxpayer has a net operating loss that he carries back to 1965 which eliminates the taxpayer's liability for tax for that year. The $25,000 credit (no longer allowable for the year 1965) is an investment credit carryover that may be carried forward to the 5 succeeding taxable years but is not to be treated as an investment credit carryback.

Taxable years beginning before July 1, 1962

Paragraph (4) of section 46(b) provides a transition rule relating to the amount of an investment credit carryback that may be added under section 46(b)(1) for a taxable year beginning before July 1, 1962, and ending after June 30, 1962. For purposes of determining the amount that may be carried back to such a taxable year, the amount of the limitation provided by section 46(a)(2) will be considered to be an amount which bears the same ratio to such limitation as the number of days in such year after June 30, 1962, bears to the total number of days in such year.

The application of the carryback and carryover of the unused credit provided for in subsection (b) of section 46 may be illustrated by the following examples:

Example 1.—A new taxpayer's credit based on his investment for the taxable year 1963 amounts to $120,000, and the limitation under section 46(a)(2) is $110,000. The taxpayer's unused credit for 1963 amounts to $10,000 ($120,000 minus $110,000), which he may carry forward to 1964 and the 4 succeeding taxable years (there is no carryback because 1963 is the taxpayer's first taxable year). The credit based on his investment for 1964 is $135,000, and the limitation under section 46(a)(2) is $120,000. Since the taxpayer is limited to a credit of $120,000 for 1964, his total unused credits to be carried forward to 1965 amount to $25,000, $10,000 from 1963 and $15,000 from 1964. There is no carryback to 1963 of the $15,000 unused credit from 1964 because the credit based on investment for 1963 already exceeds the limitation. The credit based on the taxpayer's investment for 1965 is $135,000, and the limitation under section 46(a)(2) is $140,000. The taxpayer first applies the $135,000 for 1965 against the $140,000 limitation. He next applies any unused credit carried forward from 1963 against the remaining $5,000 allowable. Since the $10,000 credit carried forward from 1963 is in excess of the $5,000 remaining amount allowable for 1965, he has unused credits to carry over to 1966 of $20,000, $5,000 from 1963 and $15,000 from 1964.

Example 2.—X files his tax return on the basis of a calendar year. X's credit based on his investment, and the limitation under section 46(a)(2) for each of the taxable years 1962 through 1968 is as follows:

	Credit	Limitation
1962	$75,000	$200,000
1963	250,000	160,000
1964	200,000	210,000
1965	210,000	230,000
1966	220,000	260,000
1967	260,000	220,000
1968	270,000	280,000

X's credit for 1962 (for investment in property acquired after June 30, 1962) is allowable in full since it is less than the limitation for that year. His credit for 1963 of $250,000 is limited by section 46(a)(2) to $160,000. The unused credit for that year of $90,000 is an investment credit carryback to 1962, and an investment credit carryover to 1964 through 1968. The amount of the 1963 unused credit that may be added for 1962 is limited to $25,822 ($200,000×184/365, less $75,000) by reason of the application of section 46(b)(4). The balance of the 1963 unused credit, $64,178 ($90,000 less $25,822) is carried forward to 1964; $10,000 of the 1963 unused credit may be added to the amount of the credit allowable in 1964 since the limitation on the credit for 1964 exceeds the credit earned for that year by $10,000 ($210,000 less $200,000). The $54,178 balance of the 1963 unused credit ($64,178 less $10,000) is then carried forward to 1965;

$20,000 of the 1963 unused credit may be added to 1965 since the limitation on the credit for 1965 exceeds the credit earned for that year by $20,000 ($230,000 less $210,000). The remaining balance of the 1963 unused credit, $34,178, is carried to 1966 and may be added in full to the amount of the credit allowable in 1966 since the limitation for that year exceeds the credit earned for that year by more than the amount of the carryover. The unused credit from 1967 of $40,000 ($260,000 credit earned less $220,000 limitation on credit) is an investment credit carryback to 1964, 1965, and 1966, and a carryover to 1968 and the 4 succeeding taxable years. None of the 1967 unused credit may be added for 1964 or 1965 because for each of those years the sum of the credit earned and allowable and the additions on account of unused credits from prior unused credit years exceeds the limitation for such years; $5,822 of the 1967 unused credit may be added for 1966 since the limitation for that year ($260,000) exceeds by $5,822 the sum of the credit earned and allowable for that year ($220,000) and the additions on account of the 1963 unused credit ($34,178); $10,000 of the 1967 unused credit may be added for 1968, and the balance ($24,178) may be carried forward to the 4 succeeding years.

(c) *Qualified investment.*—Paragraph (1) of section 46(c) defines "qualified investment" to mean, with respect to any taxable year, the aggregate of the applicable percentage of the basis of each new section 38 property placed in service by the taxpayer during such taxable year, plus the aggregate of the applicable percentage of the cost of each used section 38 property placed in service by the taxpayer during such taxable year. Under paragraph (2) of section 46(c), the applicable percentage to be applied to the basis (or cost) is (1) 33⅓ percent if the estimated useful life is 4 years or more but less than 6 years, (2) 66⅔ percent if the estimated useful life is 6 years or more but less than 8 years, and (3) 100 percent if the estimated useful life is 8 years or more.

The basis of "new section 38 property" is to be determined under the general rules for determining the basis of property. Thus, the basis of property purchased or constructed would generally be its cost. If property is acquired in a nontaxable exchange to which section 1031 applies by trading in old property and paying a cash difference, the basis of the newly acquired property would be equal to the adjusted basis of the old property, plus the cash paid. However, the basis adjustment required by section 48(g) is to be disregarded for purposes of computing the credit.

The cost of each "used section 38 property" is to be determined in accordance with section 48(c)(3)(B) and with regard to section 48(g). However, the aggregate cost of used section 38 property which may be taken into account in any taxable year in computing qualified investment cannot exceed $50,000. (See sec. 48(c)(2).)

The credit will apply to new and used property only for the first taxable year such property is placed in service by the taxpayer. The date on which property is placed in service is the first date depreciation would be allowable to the taxpayer if he computed his depreciation deduction on a daily basis. Thus, in determining the date an asset is placed in service, the fact that the taxpayer, in computing his depreciation allowance, uses an assumed timing of additions under one of the "averaging conventions" is to be disregarded, but only for the purposes of the investment credit.

The estimated useful life of any property is to be determined as of the time such property is placed in service by the taxpayer, and with reference to the useful life in the hands of the taxpayer. Thus, if a taxpayer acquires used section 38 property with a remaining useful life of 3 years in his hands, such property will not qualify regardless of the original estimated useful life to the previous owner. See section 48(d) for the useful life to be used by certain lessees. The estimate of the useful life is to be based on the facts and circumstances known on the date the asset is placed in service.

An estimated useful life must be assigned to each separate property. Thus, if a taxpayer is using a multiple-asset account, he must assign a useful life to each asset in such account for the purpose of computing his qualified investment. If a taxpayer is using a method of depreciation, such as the units of production method, which does not measure useful life in terms of years, he must estimate useful life in years in order to compute his qualified investment.

The provisions of paragraphs (1) and (2) of section 46(c) may be illustrated by the following examples:

Example 1.—Corporation Y acquires and places in service during 1963 the following new and used section 38 assets:

Property	Estimated useful life (years)	Basis or cost
A (new)	5	$60,000
B (new)	10	90,000
C (new)	6	150,000
D (used)	4	30,000

Corporation Y's qualified investment for 1963 is $220,000 determined in the following manner:

Property	Basis or cost times applicable percentage	Qualified investment
A	$60,000×33⅓ percent	$20,000
B	$90,000×100 percent	90,000
C	$150,000×66⅔ percent	100,000
D	$30,000×33⅓ percent	10,000
Total		220,000

Example 2.—Mr. X, unmarried, owns and operates a business as a sole proprietorship and reports income on a calendar-year basis. He is also a member of the XYZ partnership, which is also on a calendar-year basis. During 1963 Mr. X acquires and places in service in his sole proprietorship a new section 38 property having an estimated useful life of 9 years and a basis of $25,000. Also during 1963 the XYZ partnership acquires and places in service a new section 38 property having an estimated useful life of 4 years to the partnership and a basis of $18,000.

X's share of the basis of the new section 38 property acquired by partnership XYZ is $6,000. X's qualified investment for 1963 is $27,000, composed of $25,000 from his sole proprietorship (basis of

$25,000 times applicable percentage, 100 percent), and $2,000 attributable to the property of the XYZ partnership (basis of $6,000 times applicable percentage, 33⅓ percent).

Public utility property

Paragraph (3)(A) of section 46(c) provides that in the case of section 38 property which is public utility property, the amount of the qualified investment is to be three-sevenths of the amount ascertained under section 46(c)(1) with respect to such property.

Paragraph (3)(B) of section 46(c) defines "public utility property" as 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 sec. 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 have been established or approved by a State (as defined in sec. 7701(a)(10) of the code) 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. The term "established or approved" by a State, etc., includes the filing of a schedule of rates with any of the named bodies having the power to approve such rates, even though such body has taken no action on the filed schedule.

If a taxpayer is engaged in one or more regulated activities enumerated in section 46(c)(3)(B) (hereinafter referred to as a utility activity) and is also engaged in a separate trade or business that is not considered a utility activity, property used in the latter trade or business is not subject to the reduction contained in paragraph (3)(A) of section 46(c). If property is used by a taxpayer both in a utility activity and a nonutility activity, the characterization of such property is to be based on the predominant use of such property during the taxable year the property is placed in service. Once property is characterized as public utility property, the fact that in any subsequent year such property is used predominantly in the nonutility business is to be disregarded.

"Public utility property" includes property leased to a taxpayer which uses such property predominantly in a utility activity. Thus, property leased to a taxpayer which uses the property predominantly in a utility activity during a taxable year is to be treated as public utility property for purposes of computing the lessor's credit. "Public utility property" also includes property which is leased to others by a taxpayer where the leasing of such property is part of its utility activity.

Section 38 property which is not public utility property is not subject to the three-sevenths reduction contained in section 46(c)(3)(A). Thus, for example, in the case of property which is used predominantly in international telegraph operations, which is not used predominantly outside the United States, and which otherwise qualifies as section 38 property, the qualified investment is to be determined without reduction by reason of section 46(c)(3)(A).

The provisions of section 46(c)(3) may be illustrated by the following example:

Corporation X is engaged in a trade or business of furnishing telephone services, the rates of which have been established by a public utility commission. Corporation X is also engaged in a separate nonutility trade or business. During 1963 corporation X acquires and places in service two new section 38 properties, each with a basis of $30,000 and an estimated useful life of 7 years. One of these properties is used exclusively in the utility activity. The other property is also used at times in the utility activity, but is used in the separate nonutility trade or business more than 50 percent of the time during the taxable year 1963. Corporation X's qualified investment is $28,571 which includes $20,000 attributable to nonutility property ($30,000 basis times applicable percentage, 66⅔ percent) plus $8,571 attributable to public utility property (three-sevenths times ($30,000 basis times applicable percentage, 66⅔ percent)).

Certain replacement property

Paragraph (4) of section 46(c) is a new provision added by your committee. This new paragraph provides that, for purposes of section 46(c), if section 38 property is placed in service by the taxpayer to replace property which was destroyed or damaged by fire, storm, shipwreck, or other casualty, or was stolen, the basis (or cost in the case of used property) of such section 38 property which (but for this paragraph) would be taken into account under section 46(c)(1) as qualified investment, shall be reduced by an amount equal to the amount received by the taxpayer as compensation, or otherwise, for such property so destroyed, etc., or by an amount equal to the adjusted basis of such property so destroyed, etc., whichever is the lesser. However, the above rule shall not apply in any case in which the reduction in qualified investment attributable to the substitution required by section 47(a)(1) with respect to the property so destroyed, damaged, or stolen (determined without regard to section 47(a)(4)), is greater than the reduction in basis (or cost) described in the preceding sentence. In order to constitute replacement property, the newly acquired section 38 property need not be placed in service within the same taxable year of the destruction, etc., of the replaced property.

The provisions of paragraph (4) of section 46(c) may be illustrated by the following examples:

Example 1.—On January 1, 1964, corporation X acquires and places in service a new section 38 asset with a basis of $30,000 and a useful life of 6 years. The qualified investment with respect to such asset is $20,000 ($30,000 basis × 66⅔ percent, applicable percentage). On January 1, 1965, such asset is destroyed by fire. X receives $23,000 in insurance proceeds as compensation for the destroyed property and on December 15, 1965, purchases for $35,000 an asset to replace the asset that was destroyed. The adjusted basis of the destroyed asset on January 1, 1965 is $24,500. The basis of the replacement asset must be reduced for purposes of the new subpart B by $23,000, since that sum is less than the adjusted basis of the destroyed property on January 1, 1965 ($24,500), and is greater than the reduction in qualified investment ($20,000) which would have been required had section 47(a)(1) been applicable. Since section 46(c)(4) applies, section 47(a)(1) does not apply. (See sec. 47(a)(4).)

Example 2.—Assume the same facts as in example 1, except that the insurance proceeds are $17,000. In such case, no reduction in the basis of the replacement asset is required since the reduction in qualified investment under section 47(a)(1) ($20,000) is greater than the reduction in basis ($17,000) which would have been required under section 46(c)(4). Since section 46(c)(4) is not applicable, the credit attributable to the asset replaced will be recomputed by applying section 47(a)(1).

(*d*) *Limitations with respect to certain persons.*—Subsection (d) of section 46 limits the applicability of the credit with respect to certain persons. Paragraph (1) of section 46(d) provides that both the qualified investment and the $25,000 amount specified under subparagraphs (A) and (B) of section 46(a)(2) are to be equal to a ratable share of such items in the case of the following organizations:

(1) mutual savings banks, cooperative banks, and domestic building and loan associations, to which section 593 applies;

(2) regulated investment companies and real estate investment trusts subject to tax under subchapter M; and

(3) cooperative organizations described in section 1381(a).

Under paragraph (2)(A) of section 46(d), in the case of a mutual savings bank, etc., its ratable share of the qualified investment and the $25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) is equal to 50 percent of such items.

Under paragraph (2)(B) of section 46(d), in the case of a regulated investment company or a real estate investment trust, the qualified investment and the $25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) are to be taken into account in the same proportion as its taxable income (as defined in sec. 852(b)(2) or sec. 857(b)(2), respectively) bears to such taxable income computed without regard to the deduction for dividends paid (as defined in sec. 852(b)(2)(D) or 857(b)(2)(C), respectively).

Under paragraph (2)(C) of section 46(d), a cooperative organization described in section 1381(a) is to take into account its qualified investment and the $25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) in the same proportion as its taxable income bears to 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). Thus, in the case of a taxable year of a cooperative organization beginning before January 1, 1963, the denominator of the proportion for such organization is determined by adding to its taxable income any patronage dividends which are excluded or deducted and any nonpatronage distributions which are deducted under section 522(b)(1). In the case of any taxable year of the organization beginning after December 31, 1962, the denominator is determined by adding to taxable income (in addition to amounts to which sec. 1382 (b) or (c) applies) any amounts of the type described in the preceding sentence which are excluded or deducted without regard to section 1382 (b) or (c) because they are attributable to patronage occurring before 1963.

If any of these special taxpayers to which section 46(d) applies are members of an affiliated group as defined in section 46(a)(5), the $25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) is to be reduced in accordance with section 46(a)(5) before determining the ratable share of such item under section 46(d).

The provisions of section 46(d) may be illustrated by the following example:

The total qualified investment of a regulated investment company is $150,000, and its investment company taxable income is $50,000 after taking into account the deduction for dividends paid provided by section 852(b)(2)(D), and \$1 million without regard to such deduction. Such organization's qualified investment would be \$7,500 $\left(\$150{,}000\times\frac{\$50{,}000}{\$1{,}000{,}000}\right)$. Similarly, the \$25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) would be reduced to \$1,250 $\left(\$25{,}000\times\frac{\$50{,}000}{\$1{,}000{,}000}\right)$, and the 25-percent limitation of section 46(a)(2)(B) would apply to the tax liability in excess of \$1,250.

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

(a) *In general.*—Section 47 provides, in general, for an adjustment of prior credits (including credit carrybacks and carryovers) and an increase in the tax imposed by chapter 1 if property (1) 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 with respect to such property in computing the credit, or (2) becomes public utility property. Subsection (a) of section 47 provides that adjustments due to the application of section 47 and increases in tax resulting from such adjustments are to be determined under regulations prescribed by the Secretary of the Treasury or his delegate.

Early disposition, etc.

Under paragraph (1) of section 47(a), the tax for a taxable year in which property is disposed of or otherwise ceases to be section 38 property before the close of the useful life which was taken into account in computing the credit is to be increased by the amount by which the credits allowed under section 38 for all prior taxable years would have been decreased by reason of adjustments of the credits for such taxable years. Such adjustment is to be made by recomputing qualified investment for the year in which the basis (or cost) of the property that ceases to be section 38 property was included in qualified investment and by recomputing the credit (and credit carrybacks and carryovers) accordingly. Qualified investment is to be recomputed by substituting, in lieu of the estimated useful life of the property that was originally taken into account in applying the applicable percentage, 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. This period is hereinafter referred to as the actual period of use. In determining the amount of the aggregate decrease in the credits allowed for all prior taxable years, due regard is to be accorded any previous recomputations of qualified investment, credits, and credit carrybacks and carryovers resulting from a prior application of section 47. Of course, if the actual period of use would have no effect on the appropriate applicable percentage to be applied, no adjustment is necessary. Thus, for example, if the estimated useful life is 10 years, and a disposition occurs resulting in an actual period of use of 8 years, no adjustment results, since the applicable percentage remains 100 percent in either case.

Except as provided in section 47(b), whenever section 38 property is disposed of, such property ceases to be section 38 property with respect to the taxpayer. In general, property will be considered disposed of whenever it is sold, exchanged, transferred, distributed, involuntarily converted, or disposed of by gift. Thus, a cessation will occur when property is contributed to a partnership or to a corporation. (However, see sec. 47(b) for an exception where the contribution of property constitutes a mere change in the form of operating the trade or business.) Generally, the lease of property is not considered to be a disposition for purposes of applying section 47. However, if a taxpayer leases out property which he would ordinarily dispose of by sale or exchange and it appears that a purpose of the lease is to avoid the application of section 47, then such lease will be considered a disposition.

Additional examples of property ceasing to be section 38 property include (1) property (or a portion thereof) which is no longer subject to depreciation with respect to the taxpayer because, for example, it is shifted from a business to a personal use, and (2) property which is used in any taxable year predominantly outside the United States, by a governmental unit, etc. Similarly, property of a partnership (or subch. S corporation or estate or trust) ceases to be section 38 property with respect to the taxpayer (partner, shareholder, or beneficiary) when such taxpayer sells his interest in the partnership (or shares of stock or beneficial interest). Furthermore, when section 38 property is leased, and the lessor elects to treat the lessee as the purchaser of the property under section 48(d), a termination of the lease will result in the application of section 47 with respect to the lessee, unless the property does not cease to be section 38 property with respect to the lessee.

The provisions of section 47(a)(1) may be illustrated by the following example:

Corporation X acquires and places in service a new section 38 asset on January 1, 1963. Such asset has a basis of $30,000 (determined without regard to sec. 48(g)) and an estimated useful life of 8 years. Assuming this is the only section 38 asset corporation X places in service during its taxable year ending December 31, 1963, X's qualified investment is $30,000 ($30,000 basis times applicable percentage, 100 percent). Such investment entitles X to a credit of $2,100 (7 percent times $30,000). Corporation X's liability for tax for 1963 is $100,000, and X reduces its tax liability by the full $2,100. On January 1, 1968, corporation X sells such asset. There will be added to the taxes imposed by chapter 1 for X's taxable year ended December 31, 1968, $1,400 which is the aggregate decrease in credits allowed resulting solely from substituting a 5-year life for such asset in computing qualified investment in 1963. The sum of $1,400 is arrived at by first applying an applicable percentage of 33⅓ percent to the basis, resulting in an adjusted qualified investment of $10,000 ($30,000 basis times 33⅓ percent, the applicable percentage based on the actual period of use of 5 years). Since the recomputed qualified investment results in an adjusted credit of $700 (7 percent times $10,000), the aggregate decrease in credits is $1,400 ($2,100 credit allowed minus $700 adjusted credit).

Property becomes public utility property

Section 47(a)(2) provides that the credit is to be adjusted if during any taxable year any property previously taken into account in determining qualified investment as nonutility property becomes public utility property. Property becomes public utility property if in any 1 taxable year the property is used predominantly in a trade or business described in section 46(c)(3)(B) by the taxpayer or by a person leasing such property from the taxpayer. Once such property becomes public utility property in the hands of the taxpayer, the fact that in any subsequent year such property is used by such taxpayer predominantly in a nonutility activity is to be disregarded. (See sec. 46(c)(3)(B) for the definition of public utility property.)

In such a case, the tax liability for the taxable year in which the property becomes public utility property is to be increased by the amount that the credits allowed under section 38 for all prior taxable years is decreased by the adjustment. The adjustment is to be made by treating the property as public utility property beginning with the year the property was placed in service, but with due regard to the use of the property as nonutility property before such change in use. For purposes of the adjustment, it is assumed that the property will continue to be used as section 38 public utility property for the estimated useful life of the property which was taken into account in computing the credit in the year the property was placed in service.

If property becomes public utility property before the close of the useful life which was taken into account in computing the credit under section 38, the proper applicable percentage to be used in recomputing qualified investment is determined by adding (1) the applicable percentage (either 0, 33⅓, or 66⅔ percent) earned by the property as nonpublic utility property prior to the change in use, and (2) three-sevenths times the difference between the applicable percentage originally taken into account in computing the credit in the year the taxpayer placed the property in service and the applicable percentage determined in (1). Thus, if property with an original estimated useful life of 10 years is used predominantly as public utility property after use as nonutility property for 5 years, the applicable percentage to be used in recomputing qualified investment is 61.9 percent. This percentage is arrived at by adding 33⅓ percent (the applicable percentage earned by the property as nonpublic utility property) plus three-sevenths of 66⅔ percent (100 percent original applicable percentage, less 33⅓ percent, applicable percentage earned as nonutility property).

If property becomes public utility property and section 47(a)(2) applies, and if such property is subsequently disposed of or used in a manner causing section 47(a)(1) to apply, proper adjustment for the fact that section 47(a)(2) has previously applied is to be made in applying section 47(a)(1).

Carrybacks and carryovers adjusted

Section 47(a)(3) provides that carrybacks and carryovers of unused credits under section 46(b) are to be adjusted by reason of a disposition or other cessation described in section 47(a)(1), or by reason of a change in use described in section 47(a)(2). Thus, even if the recomputation of qualified investment required by section 47(a)(1) does not result in a decrease in the credits allowed, credit carrybacks and carryovers are to be adjusted.

The provisions of section 47(a)(3) may be illustrated by the following example:

In 1963, corporation X, a new taxpayer, acquired and placed in service a number of section 38 assets. One of these was asset A which has a basis of $300,000 and an estimated useful life of 8 years. X's qualified investment and liability for tax for such year were $2,300,000 and $525,000 respectively. In 1963, X's tentative credit was $161,000 (7 percent times $2,300,000), but because of the limitation contained in section 46(a)(2) the credit allowed for such year was $150,000 ($25,000 plus 25 percent of $500,000). Therefore, an $11,000 credit carryover was available for 1964 and succeeding years. On January 1, 1970, X trades in asset A in exchange for a new asset. Under these facts, corporation X must adjust its credit for 1963 by recomputing the qualified investment attributable to asset A. The original qualified investment with respect to asset A was $300,000 ($300,000 basis times applicable percentage, 100 percent); the recomputed qualified investment is $200,000 ($300,000 basis times applicable percentage, 66⅔ percent based on the actual period of use of asset A). Therefore, the total recomputed qualified investment is $2,200,000 ($2,300,000 minus $100,000). In this case, the adjustment of the credit for 1963 will not affect the credit allowed in 1963 but will reduce the credit allowable as a carryover to 1964 and succeeding years. This is because in recomputing the credit, X's credit is reduced to $154,000 (7 percent times $2,200,000). Since X's adjusted credit is still in excess of the limitation of $150,000 for 1963, there is no decrease in credits allowed in 1963, and hence no increase in X's liability for tax for 1970 attributable to credits allowed in 1963. Thus, only the $11,000 unused credit carryover from 1963 is affected by the recomputation. Such carryover as adjusted is $4,000 ($154,000 adjusted credit for 1963 minus $150,000 credit used in 1963). To the extent more than $4,000 of the original carryover from 1963 has been used by the taxpayer as a credit against tax for 1964 or any succeeding year, such credits shall be adjusted and the decrease attributable thereto will be added to X's 1970 tax.

Property destroyed by casualty, etc.

Paragraph (4) of section 47(a) was added to the bill by your committee. Paragraph (4) provides an exception to section 47(a)(1). If (1) any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, on account of its destruction or damage by fire, storm, shipwreck, or other casualty, or by reason of its theft, and (2) section 38 property is placed in service by the taxpayer to replace the property described in (1); and (3) the reduction in basis (or cost) of the replacement property resulting from the application of the first sentence of section 46(c)(4) is greater than the reduction in qualified investment which (but for this paragraph) would be made by reason of the substitution required by section 47(a)(1) with respect to the destroyed, etc., property, then, no increase in tax shall be made under section 47(a)(1) and no adjustment in unused credit carryovers will be made under section 47(a)(3). (See the discussion of sec. 46(c)(4) in this report for examples which illustrate the application of this provision.)

(b) *Section not to apply in certain cases.*—Subsection (b) of section 47 provides additional exceptions to the adjustments required by section 47(a).

The first exception provides that section 47(a) will have no application to the transfer of property which arises by reason of an individual taxpayer's death. Thus, on the death of an individual taxpayer, the transfer of the decedent's property interests to his personal representative or heirs will be disregarded. Nor will section 47(a) apply to the transfer of a deceased taxpayer's interest held in joint tenancy (either as a joint tenant, or a tenant by the entirety) to the surviving owners of the property. The effect of this provision is that all properties held by a decedent at the time of his death for which the credit has been granted will be deemed held by the decedent for the useful life estimated by the decedent in computing his credits.

Another exception provided by subsection (b) of section 47 is that section 47(a) will not apply to the transfer of property to the acquiring corporation in a transaction to which section 381(a) applies. (See sec. 381(c)(23) for the treatment to be accorded the acquiring corporation with respect to the credits of the acquired corporation, including the sec. 47 adjustments with respect to dispositions by the acquiring corporation of property transferred by the acquired corporation.)

In addition, subsection (b) of section 47 provides, in effect, a suspension of the application of section 47(a) where there has been a mere change in the form of conducting a trade or business so long as (1) the property is retained in such trade or business as section 38 property, and (2) the taxpayer retains a substantial interest in such trade or business. On the occurrence of any event which results in a failure to meet either of the conditions described above, the property will be deemed to cease to be section 38 property when such event occurs. Thus, in determining whether the property ceases to be section 38 property before the close of its estimated useful life, the period the property was held as section 38 property before the mere change in form of conducting the trade or business will be tacked on to the period beginning with the change in form and ending with the occurrence of the event which results in a failure to meet either of the conditions specified in the first sentence of this paragraph.

The phrase "a mere change in the form of conducting the trade or business" (whether through incorporation, the formation of a partnership, or otherwise) applies only to cases where the properties of a trade or business are transferred. Thus, the transfer of section 38 assets to a newly formed corporation in a transaction to which section 351 applies will not fall within the scope of the exception unless the transaction involves the transfer of the trade or business in which such assets were used.

The determination of whether the taxpayer has retained a substantial interest in the trade or business is to be made immediately after the change in form of conducting the business, as well as after each time the taxpayer disposes of a portion of his interest in the new enterprise. However, in any case where a taxpayer's interest in the business of the new enterprise remains constant in relation to his former interest, the taxpayer will be considered as having retained a substantial interest in the trade or business. Thus, where a taxpayer owns a 5-percent interest in a partnership, and after the incorporation of that partnership the taxpayer retains a 5-percent interest in the corporation, the taxpayer will be considered as having retained a substantial interest in the trade or business as of the date of the change in form.

The provisions of section 47(b) may be illustrated by the following examples:

Example 1.—On July 1, 1962, the XYZ partnership acquires and places in service asset A, a new section 38 asset, with a basis of $30,000 and an estimated useful life of 8 years. One-third of the basis of such asset is taken into account by each of the three partners of the XYZ partnership in computing their individual credits. On January 1, 1964, the XYZ partnership transfers all of its assets to the XYZ corporation, a newly formed corporation, in exchange for all of the stock of XYZ corporation. Such stock is then transferred pro rata to the partners. The XYZ corporation continues to operate the same trade or business formerly conducted as a partnership. On September 1, 1970, the XYZ corporation sells asset A. Assuming all the partners have continuously retained a substantial interest in the XYZ corporation and asset A was used in the business as a section 38 asset until September 1, 1970, no adjustment is required under section 47 since the total holding period of asset A for each partner exceeds 8 years (18 months while used by the XYZ partnership and 80 months while used by the XYZ corporation or a total of 8 years and 2 months).

Example 2.—On January 1, 1963, the X corporation acquires and places in service a new section 38 property (with an estimated useful life of 6 years) which it takes into account in computing a credit. Such property is used in X's manufacturing business. X corporation is also engaged in a separate personal service business. In 1964, the X corporation transfers the assets of the manufacturing business (including the sec. 38 property upon which the X corporation took a credit) to a newly formed corporation, the Y corporation. X corporation then transfers to its shareholders all of the stock of the Y corporation. Since the X corporation does not retain a substantial interest in the manufacturing business, section 47(a) will apply to the transfer of the assets to Y corporation.

(c) *Special rule.*—Subsection (c) of section 47 provides a special rule for treating the increase in tax resulting from the adjustment of the credit. In general, such increase in tax will be treated as a tax imposed by chapter 1. However, it will not be so treated for purposes of determining the amount of the credits under section 33 (relating to tax of foreign countries and possessions of the United States), section 34 (relating to dividends received by individuals), section 35 (relating to partially tax-exempt interest received by individuals), section 37 (relating to retirement income), and section 38 (relating to investment in certain depreciable property). Thus, the increase in tax is not to be taken into account in determining a taxpayer's liability for tax as defined in section 46(a)(3), and hence will have no effect on the limitation contained in section 46(a)(2). However, all adjustments to credit carryovers to the current taxable year resulting from a cessation or change in use during such taxable year are to be taken into account in determining the amount of credit carryovers which may be used for such year.

SECTION 48. DEFINITIONS; SPECIAL RULES

(a) *Section 38 property.*—Section 48 contains various definitions and special rules necessary to the application of the investment credit. Section 48(a) defines the type of property investment which will qualify for the credit.

In general

The term "section 38 property" is defined by section 48(a)(1) as property which is tangible personal property, or which is other tangible property (not including a building and its structural components) but only if such other property 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 is a research or storage facility used in connection with any of the foregoing activities. The property described above, however, must be property with respect to which depreciation (or amortization in lieu of depreciation) is allowable, and such property must have a useful life of 4 years or more (determined as of the time such property is placed in service). (See the discussion of useful life in this report under sec. 46(c), relating to qualified investment.)

If an asset is in part subject to an allowance for depreciation and in part nondepreciable, only the proportionate part of the asset which is subject to depreciation will qualify as section 38 property. Thus, if an asset is used 80 percent of the time in a trade or business and is used 20 percent of the time for personal purposes, only 80 percent of such property will qualify as section 38 property subject to depreciation. Further, property does not qualify to the extent it is treated as property which is used for personal, living, and family purposes under section 274 (relating to disallowance of certain entertainment, etc., expenses).

Property may qualify as section 38 property if amortization is allowable with respect to such property in lieu of depreciation. Amortization in lieu of depreciation is allowable, for example, if a lessee makes improvements on leased property which have a longer estimated useful life than the remaining term of the lease and amortizes the cost of such improvements over the remaining term of the lease.

Tangible personal property may qualify as section 38 property irrespective of whether it is used as an integral part of manufacturing, production, or extraction or of the furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services. Local law definitions will not be controlling for purposes of determining the meaning of the term "tangible personal property." For purposes of section 48, the term "tangible personal property" includes any tangible property except land, and improvements thereto, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). Assets accessory to the operation of a business, such as machinery, printing presses, transportation or office equipment, refrigerators, individual air-conditioning units, grocery counters, testing equipment, display racks and shelves, etc., generally constitute tangible personal property for purposes of section 48, even though such assets may be termed fixtures under local law. Further, assets in the nature of machinery will be considered "tangible personal property" for purposes of section 48 whether they are placed within or without a building or other structure. Thus, for example, a gasoline pump, or a hydraulic car lift, although not within any structure, will nevertheless be considered "tangible personal property." Intangible property, such as patents and copyrights, does not qualify as section 38 property.

Buildings and structural components thereof are not eligible for the credit. The term "building" is to be given its commonly accepted meaning, that is, a structure or edifice enclosing a space within its walls, and usually covered by a roof. It is the basic structure of an improvement to land the purpose of which is, for example, to provide shelter or housing or to provide working, office, display, or sales space.

The term would include, for example, the basic structure used as a factory, office building, warehouse, theater, railway or bus station, gymnasium, or clubhouse. The term "structural components" of a building includes such parts of the building as central air-conditioning and heating systems, plumbing, and electric wiring and lighting fixtures, relating to the operation and maintenance of the building.

In addition to tangible personal property, other tangible property (not including a building and its structural components) used as an integral part of the manufacturing, production, or extraction process or as an integral part of a system of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services may qualify for the credit. Property is to be considered as being used as an integral part of a system of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services only if such property is used by one engaged in the trade or business of furnishing such services. Thus, if a manufacturing firm constructs an airstrip for use by airplanes operated for the convenience of its officers and employees, such airstrip would not qualify as section 38 property since the manufacturing firm is not engaged in the transportation business.

The terms "manufacturing," "production," "extraction," and the businesses of furnishing "transportation," "communications," "electrical energy," "gas," "water," or "sewage disposal" services are to be given their commonly accepted meaning. Thus, for example, manufacturing or production includes the construction, reconstruction, or making of property from or with scrap, salvage, or junk material, as well as from new or raw material, (1) by processing, manipulating, refining, or changing the form of an article, or (2) by combining or assembling two or more articles, and includes the cultivation of the soil and the raising of livestock and other farm produce. Section 38 property would include, for example, property used as an integral part of the extraction, processing, refining, and fabrication of minerals or mineral products; the growing, raising, processing, and packing or packaging of foodstuffs; the operation of sawmills and the production of lumber and lumber products and other building materials; and the manufacture, treatment, and packaging of textiles, paper, leather goods, glass, etc. Examples of transportation businesses would be railroads and airlines. Examples of communications businesses would include businesses furnishing telephone and telegraph services or radio or television broadcasting stations.

In order to qualify for the credit, property (other than tangible personal property and research or storage facilities used in connection with the specified activities) must be used as an integral part of one or more of the specified activities. Thus, for example, section 38 property would ordinarily not include such assets as pavements, parking areas, advertising displays, outdoor lighting facilities, or swimming pools which, although used as a part of the overall business operation, are not used directly in the specified activities. Specific examples of qualifying property which normally would be used as an integral part of one of the specified activities are blast furnaces, oil and gas pipelines, and railroad tracks and signals. Fences will qualify as section 38 property where used as an integral part of a specified activity as, for example, where used in connection with the raising of livestock.

Research or storage facilities (other than buildings) are eligible for the credit if used in connection with any of the specified activities, although such property is not an integral part of the activity. Examples of such facilities include wind tunnels and test stands.

Property used outside the United States

Subparagraph (A) of section 48(a)(2) provides that, subject to certain exceptions contained in subparagraph (B) of that section, the term "section 38 property" does not include property used predominantly outside the United States (as defined in sec. 7701(a)(9)). The term "predominantly outside the United States" means that the property must be physically located outside the United States more than 50 percent of the time during any one taxable year. Thus, if property is originally placed in service in the United States and a credit is received on such property, but such property is thereafter in any one year used predominantly outside the United States, such property ceases to be section 38 property with respect to the taxpayer who obtained the credit, regardless of the fact that the property is later returned to the United States. Furthermore, if property is originally placed in service by the taxpayer outside the United States and is used predominantly outside the United States during the taxable year originally placed in service, such property cannot qualify as section 38 property with respect to such taxpayer.

Subparagraph (B)(i) of section 48(a)(2) provides that any aircraft which is registered by the Administrator of the Federal Aviation Agency and which is operated, whether on a scheduled or nonscheduled basis, to and from the United States may be section 38 property even though it is used predominantly outside the United States. The term "to and from" the United States is not intended to exclude an aircraft which makes flights from one point in a foreign country to another such point, as long as such aircraft returns to the United States with some degree of frequency.

Subparagraph (B)(ii) provides that rolling stock of a domestic railroad corporation subject to part I of the Interstate Commerce Act which is used within and without the United States does not lose its eligibility for the credit even though it is used predominantly outside the United States. For the purposes of subparagraph (B)(ii) the term "rolling stock" means locomotives, freight and passenger train cars, floating equipment, and miscellaneous transportation equipment on wheels, the expenditures for which are chargeable to the equipment investment accounts in the uniform system of accounts for railroad companies prescribed by the Interstate Commerce Commission.

Subparagraph (B)(iii) provides that any vessel which is documented under the laws of the United States and which is operated in the foreign or domestic commerce of the United States may qualify as section 38 property.

Subparagraph (B)(iv) provides that any motor vehicle of a U.S. person (as defined in sec. 7701(a)(30)) which is operated to and from the United States with some degree of frequency may be section 38 property even though predominantly used outside the United States.

Subparagraph (B)(v) provides that any container of a U.S. person which is used in the transportation of property to and from the United States may be section 38 property even though used predominantly outside the United States.

Subparagraph (B)(vi) provides that property (other than vessels or aircraft) of a U.S. person which is used for the purposes of exploring for, developing, removing, or transporting resources from the outer Continental Shelf of the United States (within the meaning of sec. 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U.S.C., sec. 1331) may be section 38 property. Thus, for example, the credit may be allowed for offshore drilling equipment.

Property used for lodging

The first sentence of paragraph (3) of section 48(a) provides that the term "section 38 property" does not include property which is used predominantly to furnish lodging or is used predominantly in connection with the furnishing of lodging. Thus, if property is used predominantly to furnish lodging in the year it is placed in service, it does not qualify as section 38 property. If property on which a credit has been allowed is used predominantly to furnish lodging in any subsequent year, such property will cease to be section 38 property. Property which is generally considered to be used to furnish lodging includes beds and other furniture and fixtures used in the accommodations for lodging.

The second sentence of section 48(a)(3) provides two exceptions to the rule excluding from the credit property used for lodging or in connection with the furnishing of lodging. Subparagraph (A) of such second sentence provides that nonlodging commercial facilities which are available to persons not using the lodging facilities on the same basis that they are available to persons using the lodging facilities may qualify for the credit. For example, tangible personal property used in a restaurant or pharmacy may qualify as section 38 property notwithstanding the fact that the restaurant or pharmacy is operated in connection with lodging facilities such as an apartment house. However, the furniture and fixtures, rugs, draperies, etc., used, for example, in the lobby of an apartment house would be excluded since they are furnished in connection with the furnishing of lodging and since the lobby of an apartment house is not a nonlodging commercial facility.

Subparagraph (B) of the second sentence of section 48(a)(3) provides that property used by a hotel or motel in connection with the trade or business of furnishing lodging may qualify for the credit where the predominant portion of the accommodations is used by transients. Thus, if more than half of the rooms used to accommodate guests of a hotel or motel are normally used on a transient basis, the property used in such hotel or motel may qualify for the credit even though it is used in connection with furnishing lodging. Conversely, if less than half of the accommodations are normally used on a transient basis, none of the property used in the hotel or motel may qualify for the credit except for property used in connection with a nonlodging commercial facility.

Property used by tax-exempt organizations

Paragraph (4) of section 48(a) provides that property used by an organization (other than a cooperative described in sec. 521) which is exempt from the tax imposed by chapter 1 of the code 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. The term "property used by" an organization exempt from tax includes property leased to such an organization, as well as property leased by such an organization to another person. Thus, if property does not qualify under section 48(a)(4) because it is leased to an organization exempt from tax, no credit is allowable to the lessor with respect to such property.

Property used by governmental units

Paragraph (5) of section 48(a) also excludes from the term "section 38 property" property used by the United States, any State (as defined in sec. 7701(a)(10) of the code) or political subdivision thereof, any international organization (as defined in sec. 7701(a)(18) of the code), or any agency or instrumentality of any of the foregoing.

Livestock

Paragraph (6) of section 48(a) which was added by your committee provides that livestock will not be treated as section 38 property. The term "livestock" includes horses, cattle, poultry, and fur-bearing animals, irrespective of the use to which they are put or the purpose for which they are held.

(b) *New section 38 property.*—Subsection (b) of section 48 provides that, for purposes of the credit, "new section 38 property" means only section 38 property, the construction, reconstruction, or erection of which is completed by the taxpayer after June 30, 1962, or acquired by the taxpayer after that date, provided the original use of such property commences with the taxpayer and commences after such date. In the case of property constructed, reconstructed, or erected by the taxpayer, there is to be taken into account in determining the basis of such property only that portion of the basis which is properly attributable to construction, reconstruction, or erection after June 30, 1962. The principles applicable under section 167(c) of the code are to be applied under section 48(b) in determining, for example, when the property is acquired by the taxpayer, whether the original use of the property commences with the taxpayer, and the portion of the basis of property completed after June 30, 1962, which is attributable to construction, reconstruction, or erection after that date.

(c) *Used section 38 property.*—Paragraph (1) of section 48(c) defines the term "used section 38 property" as section 38 property acquired by purchase after June 30, 1962, which is not new section 38 property.

Used section 38 property does not include property which, after its acquisition by the taxpayer, is used by a person who used such property before such acquisition. This rule also applies where the property after acquisition by the taxpayer is used by a person who is related to a person who used the property before acquisition. Such person will be considered as related if the relationship is one described in section 179(d)(2) (A) or (B) (as, for example, where the parties are members of an affiliated group, as defined in sec. 48(c)(3)(C)). Thus, if property were sold under a sale and leaseback arrangement, such property in the hands of the purchaser-lessor would not be used section 38 property since the property, after its acquisition, is being used by the same person who used it before the acquisition. Similarly, where a taxpayer has been leasing property, and subsequently purchases such property (whether or not the lease contained a purchase option feature), such property is not used section 38 property with respect to such taxpayer, since it is being used by the person who used such property before its acquisition. In addition, if property owned by a lessor is sold subject to a lease or is sold upon the termination of a lease, the property will not qualify as used section 38 property with respect to the purchaser, if thereafter the property is used by a lessee who used the property before the acquisition. For purposes of applying the rule contained in section 48(c)(1), property will be considered used by a person only if a substantial use is made. Thus, property would not be disqualified as used section 38 property merely because a person using the property after acquisition had also made some casual use of it before acquisition.

Dollar limitation

Under subparagraph (A) of section 48(c)(2), the cost of used section 38 property which may be taken into account under section 46(c)(1)(B) in computing qualified investment for any taxable year is not to exceed $50,000. If the total cost of used section 38 property placed in service during the taxable year exceeds $50,000, the taxpayer must select the particular assets he wishes to be taken into account in computing qualified investment (but not to exceed an aggregate cost of $50,000). The selection of the specific assets to be taken into account is to be made at the time and in the manner prescribed by regulations. Such selection may be changed only in the manner and to the extent provided by the regulations. Thus, if a taxpayer has a cost of used section 38 property of $25,000 acquired in connection with the operation of a sole proprietorship, $30,000 allocated to him from a subchapter S corporation, and $20,000 which is his share of the cost of used section 38 property acquired by a partnership of which he is a member, he may select from the total of $75,000 the particular assets which he wishes to take into account for purposes of computing qualified investment. If the assets selected all have useful lives of between 4 and 6 years, the maximum qualified investment in used section 38 property will be $16,667. If the assets selected all have useful lives in excess of 8 years, qualified investment in used section 38 property would be $50,000.

Subparagraph (B) of section 48(c)(2) provides that in the case of a husband or wife filing a separate return, the cost of used section 38 property that may be taken into account is not to exceed $25,000. If this subparagraph applies, and such cost exceeds $25,000, the husband or wife may select, under regulations prescribed by the Secretary of the Treasury or his delegate, the assets to be taken into account, but only to the extent of an aggregate cost of $25,000. Subparagraph (B) shall apply, however, only if the spouse of the taxpayer has purchased (or has been allocated) used section 38 property which may be taken into account in qualified investment for the taxable year of such spouse which ends within or with the taxpayer's taxable year. Thus, if both husband and wife have purchased (or have been allocated) any used section 38 assets for the taxable year (as described above) and they file separate returns, the maximum cost of used section 38 property which may be taken into account by each is $25,000; but if only one spouse has purchased (or has been allocated) any used section 38 assets, such spouse may take into account $50,000 of the cost of used section 38 property.

Subparagraph (C) of section 48(c)(2) provides that in the case of an affiliated group, the $50,000 limitation is to be reduced for each member of the group by apportioning the $50,000 limitation among the members of the affiliated group in accordance with their respective amounts of used section 38 property which may be taken into account. The phrase, "their respective amounts of used section 38 property which may be taken into account", has reference to the total cost of used section 38 property without regard to the $50,000 limitation or the applicable percentages to be applied in computing qualified investment. An affiliated group is one defined in section 1504(a) except that the phrase "more than 50 percent" is to be substituted for the phrase "at least 80 percent" each place it appears in section 1504 (a), and all corporations are to be treated as includible corporations. Thus, even if a corporation is excluded under section 1504(b) from being a member of an affiliated group for purposes of filing a consolidated return, it nevertheless will be treated as an includible corporation for purposes of section 48(c).

Subparagraph (D) of section 48(c)(2) provides that, in the case of partnerships, the limitation on the amount of used section 38 property which may be taken into account is to apply both with respect to the partnership and with respect to each partner. Thus, a partnership will be limited to used section 38 property having a cost of $50,000 regardless of the number of partners.

If the aggregate cost of used section 38 property purchased by the partnership during a taxable year exceeds $50,000, the partnership, under regulations prescribed by the Secretary of the Treasury or his delegate, is to select the properties, the cost of which is to be taken into account by the partners. Each partner will then combine his share of the cost of the used section 38 property selected by the partnership with the cost of any other used section 38 property to which he may be entitled. This combined amount may not exceed $50,000 (or $25,000 in the case of certain married individuals under section 48(c)(2)(B)). If such amount exceeds $50,000, the taxpayer will then select the properties to which the applicable percentages are to be applied in computing his qualified investment.

Definitions

Subparagraph (A) of section 48(c)(3) provides that the principles of section 179(d)(2) of the code are to be applied in determining whether the property has been acquired by purchase. Thus, for example, used section 38 property is not acquired by purchase if it is acquired from a person whose relationship to the person acquiring it would result in the disallowance of a loss under section 267 or 707(b) (except that in applying sec. 267 (b) and (c), the family of an individual includes only his spouse, ancestors, and lineal descendants, and not his brothers and sisters). Furthermore, the term "purchase" does not include the acquisition of property by one member of an affiliated group (as defined in sec. 48(c)(3)(C)) from another member of the same affiliated group, or the acquisition of property the basis of which is determined in whole or in part by reference to the adjusted basis in the hands of person from whom acquired, or under 1014(a) (relating to property acquired from a decedent).

Subparagraph (B) of section 48(c)(3) provides that 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. Thus, for example, if the basis of used section 38 property acquired is determined under section 1031 (relating to certain nontaxable exchanges), the preceding rule applies. In addition, if property is disposed of (other than by reason of its destruction or damage by fire, storm, shipwreck, or other casualty, or its theft) and used section 38 property which is similar or related in service or use is acquired as a replacement therefor (whether before or after the disposition), in a transaction to which the preceding rule does not apply, the cost of the used section 38 property acquired is the basis of such property, reduced by the adjusted basis of the property replaced. In such a case, if the basis of the replacement asset is $2,000 and the adjusted basis of the replaced asset is $1,200 at the time of its disposition, the cost of used section 38 property would be $800. Notwithstanding the rules described in this paragraph, the cost of used section 38 property is not to be reduced by the adjusted basis of any property disposed of if by reason of section 47 the disposition of such property gives rise to an increase of tax or a reduction of unused credit carrybacks or carryovers. The cost of used section 38 property acquired as a replacement for property which is destroyed or damaged by fire, storm, shipwreck, or other casualty, or which is stolen, shall be determined under section 46(c)(4).

(d) *Certain leased property.*—Subsection (d) of section 48 provides that in certain cases where property is leased, the lessor may elect to treat the lessee as having acquired such property. This rule applies only with respect to property which is new section 38 property in the hands of the lessor. Thus, for example, the election may not be made with respect to property owned by an organization exempt from tax unless the property is used predominantly in an unrelated trade or business, the income of which is subject to tax under section 511.

In addition, the election may be made only with respect to the first lessee of such new section 38 property, and only if such property would constitute new section 38 property if such lessee had actually acquired the property. Thus, for example, the election cannot be made if the first lessee uses the property predominantly outside the United States.

Also, for purposes of determining whether such property would constitute new section 38 property if purchased by the lessee, the original use of the property will be deemed to commence with the first lessee if he is the first person to use such property for its intended function. Thus, the fact that the lessor may have, for example, tested, stored, or attempted to lease the property to other persons will not preclude the lessee from being deemed the original user as long as neither the lessor nor any other person has physically used the property for its intended function before its use by the lessee. Moreover, in determining whether the property qualifies as new section 38 property to the lessee and in determining the amount of his qualified investment with respect to such property, the estimated useful life of the property to the lessee will be deemed to be the estimated useful life in the hands of the lessor. The election is not available if the lessor is a person referred to in section 46(d); i.e., a mutual savings bank, cooperative bank, or domestic building and loan association to which section 593 applies; a regulated investment company or real estate investment trust subject to taxation under subchapter M; or a cooperative organization described in section 1381(a).

If the election is made, the lessee will be treated for all purposes of subpart B as though he had acquired the property. Thus, if the leased property is disposed of by the lessee, or if it otherwise ceases to be section 38 property to him, such property will be subject to the provisions of section 47 applicable to such cessations. Also, if the first lessee of property is treated as having acquired such property, the lessor is thereafter precluded from obtaining a credit as to such property. The election under section 48(d) will be made at such time, in such manner, and subject to such conditions as may be provided in regulations prescribed by the Secretary of the Treasury or his delegate.

In any case in which the lessee is treated as having acquired the property, the lessee's investment is deemed to be equal to the fair market value of the property if such property is constructed by the lessor or by a corporation which controls or is controlled by the lessor within the meaning of section 368(c). In any other case the lessee's investment is the basis of the property in the hands of the lessor.

A new sentence has been added to the provisions of section 48(d) as contained in the House bill. This sentence provides that if a lessor makes the election under section 48(d) in respect of any property, then under regulations prescribed by the Secretary of the Treasury or his delegate, section 48(g) shall not apply with respect to such property, and the deductions otherwise allowable to the lessee for amounts paid to the lessor under the lease will be adjusted in a manner consistent with the provisions of section 48(g). Thus, rather than the lessor being required to reduce the basis of the property in respect of which he has elected to treat the lessee as a purchaser, the lessee will be required to reduce the amount of his deductions for rental payments (over a period of time, as provided by regulations) by an amount equal to the credit (determined without regard to the limitation contained in sec. 46(a)(2)).

If, because of a credit or unused credit, a lessee's rental deductions have been reduced, and such credit or unused credit is later reduced because of the application of section 47(a), then an adjustment to the lessee's rental deductions shall be made (in a manner consistent with sec. 48(g)(2) and under regulations prescribed by the Secretary of the Treasury or his delegate) to the extent of the prior diminution of rental deductions attributable to such credit or unused credit.

The provisions of section 48(d) may be illustrated by the following example:

X corporation is engaged in the business of manufacturing and leasing new and reconditioned equipment which in its hands has an estimated useful life of 8 years. After December 31, 1962, X corporation constructs machine No. 1, having a fair market value of $15,000 and a cost of $10,000, and reconditions machine No. 2 at a cost of $5,000. Y corporation leases both machines from X immediately after their construction and reconditioning and before X has made any other use of such machines. As to machine No. 1, if X elects to treat the property as being acquired by Y, such machine will have a basis of $15,000 in Y's hands, and an estimated useful life of 8 years, for purposes of determining qualified investment (assuming the property otherwise qualifies as new sec. 38 property in Y's hands). Y's rental deductions will be reduced (in the manner prescribed by regulations) by an aggregate amount equal to the credit attributable to such property, $1,050 (7 percent times basis of $15,000). The election is not available with respect to machine No. 2, since a reconditioned machine would not constitute new section 38 property if the lessee had purchased it. In such a case, while X corporation cannot make the election to let the Y corporation take the credit, X corporation would be entitled to a credit based on its expenditure of $5,000 as an investment in new section 38 property, the reconstruction of which is completed after December 31, 1962.

(e) *Subchapter S corporations.*—Subsection (e) of section 48 provides for the application of the credit in the case of an electing small business corporation under subchapter S. The qualified investment of the subchapter S corporation is allocated pro rata among the persons who are shareholders on the last day of the corporation's taxable year. The qualified investment is ascertained at the corporate level, and thus the aggregate cost of used section 38 property that may be allocated to the shareholders is limited to $50,000. If the cost of used section 38 property purchased by the subchapter S corporation exceeds $50,000 in any one taxable year, the corporation is to select, under regulations prescribed by the Secretary of the Treasury or his delegate, the properties the cost of which may be taken into account by its shareholders.

Any person to whom an investment is apportioned under subsection (e) of section 48 is to be treated as the taxpayer with respect to such investment, and such investment will not (by reason of such apportionment) lose its character in his hands as an investment in either new or used section 38 property. Thus, each shareholder will take into account, in determining his own qualified investment, his allocated share of the corporation's qualified investment in new section 38 property. He will also take into account his allocated share of the corporation's investment in used section 38 property. Of course, since only $50,000 cost of used section 38 property may be taken into account, if a shareholder's combined cost of used section 38 property exceeds $50,000, he must select the properties to be taken into account in computing his qualified investment.

If a shareholder includes in his qualified investment any portion of the basis or cost of property acquired by the subchapter S corporation and the corporation subsequently disposes of such property, or if the shareholder disposes of his stock in such corporation, the shareholder will be subject to the provisions of section 47 with respect to such property.

(f) *Estates and trusts.*—Subsection (f) of section 48 provides rules for applying the investment credit to estates and trusts. Paragraph (1) of section 48(f) provides that the qualified investment for any taxable year is to be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each. The qualified investment is ascertained at the trust or estate level, and thus the aggregate cost of used section 38 property that may be apportioned between the estate or trust and the beneficiaries is limited to $50,000. If the cost of used section 38 property purchased by the estate or trust exceeds $50,000 in any one taxable year, the estate or trust is to select, under regulations prescribed by the Secretary of the Treasury or his delegate, the properties the cost of which may be taken into account.

Paragraph (2) of section 48(f) provides that any beneficiary to whom the investment is apportioned is to be treated as the taxpayer with respect to such investment, and such investment will not (by reason of such apportionment) lose its character as an investment in either new or used section 38 property. If the combined cost of used section 38 property available from all sources to any beneficiary exceeds $50,000, such beneficiary must select the properties the cost of which is to be taken into account in computing his qualified investment. The term "beneficiaries" as used in section 48(f) includes heirs, legatees, and devisees.

Paragraph (3) of section 48(f) provides that the $25,000 amount specified under subparagraphs (A) and (B) of section 46(a)(2) applicable to such estate or trust is to 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) of section 48(f) bears to the entire amount of the qualified investment. Thus, in a case where the qualified investment of the estate or trust is $1 million, and $250,000 of such amount is allocated to the estate or trust because 25 percent of the income is allocable to the estate or trust, the $25,000 amount in the case of such estate or trust is reduced to $6,250.

(g) *Adjustments to basis of property.*—Subsection (g) of section 48 was added to the bill by your committee. Paragraph (1) of section 48(g) provides the general rule that the basis of any section 38 property shall (for purposes of subtitle A, relating to income tax, other than for purposes of new subpart B of pt. IV of subch. A of ch. 1) be reduced by an amount equal to 7 percent of the qualified investment of such property as determined under section 46(c). Thus, an adjustment to basis must be made even though the limitation under section 46(a)(2) reduces the amount of the credit the taxpayer may take into account. Such reduction in basis shall be made before any depreciation deductions are computed. It shall also be taken into account for purposes of determining gain or loss on the sale or disposition of the property, and for any other purpose for which the determination of basis is relevant, except that such adjustment shall be disregarded for purposes of computing (or recomputing) the credit under section 38. No adjustment to basis shall be made in the case of property with respect to which an election under section 48(d) (election of lessor to treat lessee as having acquired the property) has been made. (See sec. 48(d).) If the cost of used section 38 property for any taxable year exceeds $50,000, the basis of only those assets selected to be taken into account under section 46(c)(1)(B) shall be adjusted.

Paragraph (2) of section 48(g) provides that if the tax under chapter 1 of the code is increased for any taxable year under paragraphs (1) or (2) of section 47(a) (relating to certain dispositions, etc., of sec. 38 property) or an adjustment in carrybacks or carryovers is made under paragraph (3) of such section, the basis of the property described in section 47(a) (1) or (2) shall be increased by an amount equal to the portion of the increase in tax and adjustments to carrybacks or carryovers attributable to such property. Whenever the preceding sentence applies, the increase in the basis of the property shall be made immediately before the event causing the application of section 47(a) (1) or (2). Thus, the adjustment will be taken into account for purposes of determining gain or loss on a disposition of the property. (In the case of property subject to an election under section 48(d), see sec. 48(d).)

The provisions of paragraphs (1) and (2) of section 48(g) may be illustrated by the following example:

Corporation X acquires and places in service a new section 38 asset on January 1, 1964, the first day of its first taxable year. Such asset has a basis of $60,000 and an estimated useful life of 10 years. Corporation X's credit is $4,200 (7 percent times $60,000, qualified investment), but since X's liability for tax (as defined in sec. 46(a)(3)) is only $4,000, X can only take into account $4,000 of its credit. X will have an unused credit carryover of $200. However, X must reduce the $60,000 basis of its section 38 asset by the full $4,200 credit. The basis of such section 38 asset for purposes of computing a depreciation allowance for the year ending December 31, 1964, is $55,800 ($60,000 basis less $4,200 credit determined without regard to the limitation of sec. 46(a)(2)). On June 30, 1965, corporation X sells such asset. There will be added to the taxes imposed by chapter 1 for X's taxable year ending December 31, 1965, $4,000 (the aggregate decrease in the credits allowed resulting solely from substituting a 1½-year life for such asset in recomputing qualified investment for 1964). The unused credit carryover to 1965 is reduced from $200 to zero. (See sec. 47(a)(3).) The basis of such asset immediately prior to the sale on June 30 shall be increased by $4,200 ($4,000, the increase in tax, plus $200, the adjustment in carryovers, attributable to the property).

(c) *Deduction for unused credit.*—Subsection (c) of section 2 of the bill was added by your committee. It adds new section 181 to part VI of subchapter B of chapter 1 (relating to itemized deductions for individuals and corporations). Section 181 provides that if the amount of the credit earned (after taking into account any reductions in credit and credit carryovers resulting from the application of sec. 47(a)) exceeds the limitation provided by section 46(a)(2) for any taxable year, and if any portion of such excess credit has not, after the application of section 46(b) (relating to a 3-year carryback and a 5-year carryover of unused credits), been allowed to the taxpayer as a credit under section 38 for any taxable year, then an amount equal to such portion shall be allowed to the taxpayer as a deduction for the first taxable year following the last taxable year in which such portion could under section 46(b) have been allowed as a credit. In the case of property with respect to which an election under section 48(d) has been made, the lessee of such property is the taxpayer and will be entitled to such deduction.

However, if a taxpayer dies or ceases to exist prior to the first taxable year following the normal expiration of an unused credit carryover (5 years), an amount equal to the unused credit, or an amount equal to the proper portion thereof, shall, under regulations prescribed by the Secretary of the Treasury or his delegate, be allowed to the taxpayer as a deduction for the taxable year in which such death or cessation occurs. The preceding rule shall not apply to a corporate acquisition to which new paragraph (23) of section 381(c) applies. A "proper portion" of the unused credit carryover means that a deduction shall be allowed only to the extent that the reduction in basis under section 48(g) (or reduction in lease payments under sec. 48(d)) has caused a diminution of prior depreciation allowances (or rental payments).

The provisions of section 181 may be illustrated by the following examples:

Example 1.—Y corporation's credit based on its investment for the calendar year ending December 31, 1964, its first taxable year, amounts to $100,000, and the limitation under section 46(a)(2) is $60,000. Y's unused credit for 1964 is $40,000 ($100,000 minus

$60,000), which it may carry forward to 1965, and the 4 succeeding taxable years. However, because of successive net operating losses through 1969, Y is unable to use any portion of the $40,000 as a credit against tax; nor has the $40,000 unused credit carryover been adjusted under section 47(a)(3). For the taxable year ending December 31, 1970, Y, in computing its taxable income, may take a deduction for $40,000 under the new section 181.

Example 2.—Corporation X acquires and places in service a new section 38 asset, asset A, on January 1, 1964, the first day of its first taxable year. Asset A has an estimated useful life of 4 years. The credit with respect to such asset is $50,000, but because of the limitation based on tax, only $30,000 is taken into account as a credit in 1964. X has an unused credit carryover of $20,000 which may be carried forward through 1969. Because of substantial purchases of section 38 property in 1965, 1966, 1967, and 1968, X is unable to use any portion of the $20,000 credit carryover as a credit against tax. By 1968, asset A has been fully depreciated. On December 31, 1968, X distributes all of its assets in complete liquidation and dissolves. The transaction is not one to which section 381(c) applies, and section 48(g)(2) does not apply to the transfer of asset A. For the taxable year ending December 31, 1968, X, in computing its taxable income, may take a deduction for $20,000 under section 181.

(d) *Certain corporate acquisitions.*—Subsection (d) of section 2 of the bill, which corresponds to subsection (c) of section 2 of the bill as passed by the House, provides an amendment to section 381(c) of the 1954 Code (relating to the carryover of tax attributes in the case of certain corporate acquisitions) by adding paragraph (23) thereto. Section 381(c)(23) provides that the acquiring corporation is to take into account (to the extent proper to carry out the purposes of sec. 381 and sec. 38, and under such regulations as may be prescribed by the Secretary of the Treasury or his delegate) the items required to be taken into account for purposes of section 38 in respect of the distributor or transferor corporation. Thus, for example, the regulations under section 381(c)(23) will provide rules for the carryover of any unused credit carryovers of the distributor or transferor corporation, for the application of new section 181, and for the application of section 47 to dispositions by the acquiring corporation of property acquired from the distributor or transferor corporation.

(e) *Statutes of limitations and interest relating to investment credit carrybacks.*—Subsection (e) of section 2 of the bill, which was added to the bill by your committee, amends certain provisions of the code relating to statutes of limitations and interest. These amendments were made necessary by the adoption of the provision allowing a 3-year carryback of any unused investment credit.

Paragraph (1) of section 2(e) of the bill amends section 6501, relating to limitations on assessment and collection, to provide that in the case of a deficiency attributable to the application of an investment credit carryback, the deficiency may be assessed at any time before the expiration of the period within which a deficiency may be assessed for the taxable year in which the unused investment credit arose (i.e., the unused credit year) which results in such carryback. This provision in effect suspends the statute of limitations on the assessment of a deficiency on account of the disallowance of an erroneous or improper investment credit carryback until the expiration of the statutory period of limitation on assessments attributable to the taxable year from which the investment credit carryback arose.

Paragraph (2) of section 2(e) of the bill amends subsection (d) of section 6511, relating to limitations on credit or refund, by adding a new paragraph (4) thereto, entitled "Special period of limitation with respect to investment credit carrybacks." Subparagraph (A) of new paragraph (4) provides that a claim for credit or refund relating to an investment credit carryback may be filed at any time before the 15th day of the 40th month (or 39th month, in the case of a corporation) following the end of the taxable year of the unused investment credit which gave rise to the carryback, or within the period prescribed in section 6511(c) in respect of such year (relating to special rules applicable in case of extension of time by agreement), whichever expires later. Subparagraph (A) of new paragraph (4) also provides that in the case of such a claim, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in section 6511 (b)(2) or (c), depending on whichever is applicable, to the extent of the amount of the overpayment which is attributable to the carryback.

Subparagraph (B) of new paragraph (4) of section 6511(d) provides rules for the application of the special period of limitation with respect to the investment credit carryback. Subparagraph (B) provides that if the allowance of a credit or refund of an overpayment of tax attributable to an investment credit carryback is otherwise prevented by operation of any law or rule of law other than section 7122, relating to compromises, such credit or refund may be allowed or made, if a claim therefore is filed within the period provided in section 6511(d)(4)(A). In the case of any such claim for credit or refund, the determination by any court, including the Tax Court, in any proceeding in which the decision of the court has become final, shall not be conclusive with respect to the investment credit, and the effect of such credit, to the extent that such credit is affected by a carryback which was not an issue in such proceedings.

Paragraph (3) of section 2(e) of the bill amends subsection (e) of section 6601 (relating to interest on underpayment, nonpayment, or extensions of time for payment of tax) to provide that if the credit allowed by section 38 for any taxable year is increased by reason of an investment credit carryback, the increase shall not affect the computation of interest under section 6601 for the period ending with the last day of the taxable year in which the investment credit carryback arises (the unused credit year).

Paragraph (4) of section 2(e) of the bill amends subsection (f) of section 6611, relating to interest on overpayments, to provide that for purposes of the payment of interest on an overpayment of tax resulting from an investment credit carryback, such overpayment will be deemed not to have been made prior to the close of the taxable year in which the investment credit carryback arises. Thus, if an unused investment credit for the calendar year 1968 is carried back to 1965, and an overpayment of tax for the year 1965 results, no interest will be allowed or paid in respect of such overpayment for any period prior to December 31, 1968.

(f) *Technical amendment.*—Subsection (f) of section 2 of the bill, which was added by your committee, amends section 1016(a) of the 1954 Code, relating to adjustments to basis, by adding a new paragraph 19 thereto. Under the new section 1016(a)(19), an adjustment must be made to the basis of property which is or has been section 38 property, to the extent provided in section 48(g).

(g) *Clerical amendments.*—Subsection (g) of section 2 of the bill, provides a clerical amendment to part IV of of subchapter A and part VI of subchapter B of chapter 1 of the 1954 Code.

(h) *Effective date.*—Subsection (h) of section 2 of the bill provides that the amendments made by section 2 of the bill are to apply with respect to taxable years ending after June 30, 1962.

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

Except for the addition by your committee of a provision relating to stockholders and employees, this section is identical to section 3 of the bill as passed by the House. Subsection (a) of section 3 amends section 162 (relating to trade or business expenses) by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) a new subsection (e) relating to appearances, etc., with respect to legislation.

Paragraph (1) of the new subsection (e) provides that the deduction allowed by subsection (a) of section 162 is to include all of the following ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business: (1) expenses in direct connection with appearances before, submission of statements to, or sending communications to, the committees, or individual members, of Federal, State, or local legislative bodies with respect to legislation or proposed legislation of direct interest to the taxpayer, (2) expenses 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, (3) that portion of dues with respect to any organization of which the taxpayer is a member which is attributable to the expenses of the activities above described in this paragraph which are carried on by such organization, and (4) expenses in direct connection with communication of information between the taxpayer and an employee or stockholder with respect to legislation or proposed legislation of direct interest to the taxpayer. Paragraph (1) also provides that the expenses referred to therein are to include, but not be limited to, the cost of preparing testimony and traveling expenses described in subsection (a)(2) of section 162.

Paragraph (2) of the new subsection (e) provides that the provisions of paragraph (1) are not to be construed as allowing the deduction of any amount paid or incurred (whether by way of contribution, gift, or otherwise)—

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

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

Subsection (b) of this section of the bill provides that the amendments made by subsection (a) are to apply to taxable years beginning after December 31, 1962.

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

(a) *Denial of deduction.*—Subsection (a) of section 4 of the bill adds to part IX of subchapter B of chapter 1 of the code (relating to items not deductible in computing taxable income) a new section 274.

SECTION 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

Section 274 provides generally that certain expenses deductible in full under present law will be partially or completely disallowed for purposes of chapter 1 of subtitle A. Since section 274 is a disallowance provision exclusively, no expense would become deductible by reason of its enactment. In other words, the tests for deductibility under provisions of existing law (such as secs. 162, 165, 167, and 212) must first be met before the provisions of section 274 become operative. In addition, subsection (d) (relating to substantiation) of the new section 274 must be applied before determining the extent to which an expense or other item is disallowed under subsection (a), (b), or (c) of section 274.

(a) *Entertainment, amusement, or recreation.*—

Activity.—Paragraph (1)(A) of subsection (a) of new section 274 provides that no deduction otherwise allowable under chapter 1 of the 1954 Code is to be allowed for any item 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 or associated with the active conduct of his trade or business. Such deduction in no event is to exceed the portion of such item directly related to or associated with the active conduct of the taxpayer's trade or business.

Examples of "entertainment, amusement, or recreation" are entertaining guests at nightclubs, country clubs, theaters, football games, and prizefights, and on hunting, fishing, vacation, and similar trips. In addition, "entertainment" includes satisfying the personal, living, or family needs of any individual (which would otherwise constitute a business expense to the taxpayer) such as the furnishing of food and beverages, a hotel suite, or an automobile. By referring to an activity which "is of a type generally considered to constitute" entertainment, amusement, or recreation, the subsection provides an objective test for determining whether an activity is to be treated under this new provision.

Facilities.—Paragraph (1)(B) of subsection (a) of new section 274 provides that no deduction otherwise allowable under chapter 1 of the code is to be allowed for any item with respect to a facility used in connection with an activity generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the facility was used primarily for the furtherance of his trade or business, and that the item was directly related to or associated with the active conduct of his trade or business. Such deduction in no event is to exceed the portion of such item directly related to or associated with the active conduct of the taxpayer's trade or business. The same tests for determining whether an item is directly related to or associated with the active conduct of a trade or business apply as in the case of an item under paragraph (1)(A).

The term "facility" includes any item of personal or real property owned or rented by the taxpayer, such as a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, automobile, airplane, apartment, hotel suite, dining room, and cafeteria. In addition to the items more commonly regarded as "expenses" for entertaining, discussed above, paragraph (1)(B) also relates to other items, such as depreciation and losses realized on certain sales.

Under paragraph (1)(B), in addition to the requirement that the item be directly related to or associated with the active conduct of the taxpayer's trade or business, the facility must be used primarily for the furtherance of the taxpayer's trade or business. Thus, if a facility is used more than one-half for business entertaining, so that more than one-half of the entertainment expense with respect to such facility would be deductible as a business expense under present law, that portion is still to be deductible to the extent it meets the test of being directly related to or associated with the active conduct of the taxpayer's trade or business. If less than one-half of such entertainment expense would be deductible under present law, no deduction is to be allowed.

Paragraph (2) of subsection (a) of new section 274 prescribes two special rules for purposes of applying paragraph (1). All dues and fees paid to any social, athletic, or sporting club or organization will be treated as items with respect to a facility used for entertaining. Thus, only if the taxpayer uses a country club to which he belongs primarily for the furtherance of his business will a deduction be allowed for dues or fees paid to such club, and then only to the extent that such use is directly related to or associated with the active conduct of his business. In addition, in applying paragraph (1) an activity described in section 212 (relating to expenses for the production of income) is to be treated as a trade or business.

(b) *Gifts.*—Subsection (b)(1) of new section 274 is the same as passed by the House except that your committee has added three exceptions to the term "gift." Generally, subsection (b)(1) disallows all expenses for gifts to individuals in excess of a cumulative total of $25 per year per recipient. The reference to "indirect" gifts in this subsection includes situations where the gift is intended for the eventual use or benefit of an individual but is made initially to his corporation or to some member of his family. The term "gift", for purposes of section 274, has, in general, the same meaning as it does under section 102 of the code (relating to the exclusion of gifts and inheritances from gross income).

Any item which is excludable from gross income under a provision of chapter 1 of the code other than section 102 is not a "gift" within the meaning of subsection (b)(1). To illustrate the applicability of subsection (b)(1), a payment by an employer to a deceased employee's widow which is excludable from her income by reason of the gift exclusion provision, section 102, will not be deductible by the employer in excess of $25, whereas the treatment by an employer of a payment to a deceased employee's widow which is not a gift but which constitutes an employee's death benefit excludable by the recipient under section 101(b) of the code will not be affected by this provision. As another example, amounts paid to an individual as a scholarship which are excludable from the individual's gross income under section 117 of the code are not "gifts" within the meaning of this subsection. Similarly, those prizes and awards which are excludable from a recipient's gross income under section 74(b) of the code are not "gifts" within the meaning of this subsection.

Subparagraph (A) sets forth the first exception to the term "gift" added by your committee. It provides that the term "gift" does not include an item which cost the taxpayer not more than $4 on which the name of the taxpayer is clearly and permanently imprinted and which is one of a number of identical items distributed generally by the taxpayer. Thus, the deductibility of the cost of any such item will not be affected by section 274(b) and the taxpayer will not have to take such items into account in connection with the $25 limitation in such section.

The second exception, in subparagraph (B), excludes from the term "gift" any sign, display rack, or other promotional material to be used on the business premises of the recipient. Such items are sometimes referred to as "point-of-purchase" advertising materials.

Subparagraph (C) contains the third exception to the term "gift" added by your committee. It provides that "gift" does not include an item of tangible personal property, such as a watch, which costs the taxpayer not more than $100 and which the taxpayer awarded to an employee because of his length of service or for his safety achievement. This exception relates only to deductibility by the employer. It is not intended to have any effect in determining whether the employee who receives the award is to be taxed on its value.

Since the question in subsection (b)(1) is what portion of the taxpayer's expense will be disallowed, the $25 amount necessarily relates to the taxpayer's cost rather than to the value of the property to the donee. However, certain incidental costs, such as packaging, insurance, and mailing or other delivery, will be disregarded in determining whether the $25 limit has been exceeded.

There is a possibility of overlapping application of subsections (a) and (b), since some items can reasonably be classified both as gifts and as entertainment. Different rules under section 274 apply depending on the classification of the item. As described in greater detail below, the express authority given to the Secretary of the Treasury or his delegate to prescribe regulations will be used to solve these problems of classification so as to clarify and make more certain the application of section 274.

Subsection (b)(2) prescribes two special rules for applying subsection (b)(1). Under subsection (b)(2)(A), in the case of a gift by a partnership (including a gift made by a partner with respect to the business of the partnership), the $25 limitation will be applied at the partnership level, as well as at the level of the individual partner. Thus, deductions for gifts made with respect to partnership business will not exceed $25 per recipient, regardless of the number of partners.

Under subsection (b)(2)(B), a husband and wife are for purposes of subsection (b)(1) treated as one "taxpayer". Thus, in the case of a gift by a husband and wife, the spouses will be treated as one donor. However, since "taxpayer" in subsection (b)(1) refers only to the donor of a gift, this special rule does not pertain to gifts, for example, made by an individual to a husband and wife who are partners in a business.

(c) *Traveling.*—This is a new subsection adopted by your committee. Under present law if a taxpayer travels to a destination and while at such destination engages in both business activities (or activities described in section 212) and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the primary purpose is business the entire amount of such traveling expenses is deductible. If the trip is primarily personal in nature no part of the traveling expenses to and from the destination is deductible even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination which are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

The new subsection (c) which your committee has added to section 274 provides that in the case of any individual who is traveling away from home in pursuit of a trade or business or in pursuit of an activity described in section 212, no deduction shall be allowed under section 162 or section 212 for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary of the Treasury or his delegate, is not allocable to such trade or business or to such activity. Under this provision a taxpayer must meet two tests before he becomes entitled to deduct traveling expenses. First, the expenditure must be deductible under the rules of section 162 or 212. If it is not deductible under those sections the taxpayer gets no deduction and no reference to the rules of section 274(c) is necessary. However, if an expenditure is deductible under section 162 or 212 then the expenditure must be subjected to the allocation rules of section 274(c) to determine the extent to which the expenditure is ultimately deductible.

To avoid the application of section 274(c) in cases where the possibilities of abuse are relatively small your committee's amendment provides that the provision shall not apply to the expenses of any travel away from home which does not exceed 1 week or where the portion of the time away from home which is not attributable to the pursuit of the taxpayer's trade or business or an activity described in section 212 is less than 25 percent of the total time away from home on such travel.

The operation of subsection (c) may be illustrated by the following examples:

Example 1.—Taxpayer A flew from New York to London where he conducted business for 2 days. A then flew to Stockholm for a 14-day vacation after which he flew back to New York from Stockholm. The trip took 18 days, 2 of which were attributable to the flight to London and return. A would not have made the trip except for the business he had to conduct in London. Under present law A could deduct the entire cost attributable to transportation and food to and from London and the food and lodging during the 2 days spent on business in London. The traveling expenses attributable to the vacation part of his trip including transportation, food, and lodging would not be deductible under present law. Such personal expenditures would also not be deductible under section 274(c) in the bill. In addition under such section, since the travel away from home exceeded a week and the time devoted to personal activities was not less than 25 percent of the total time away from home, it is contemplated that the regulations will provide that fourteen-eighteenths (14 days devoted to personal activities out of a total of 18 days away from home on the trip) of the costs attributable to transportation and food to and from London are to be disallowed. The deductibility of cost of the food and lodging during the 2 days spent on business in London would be determined under section 162(a)(2), as amended by the bill.

Example 2.—Taxpayer B flew from New York to Paris where he conducted business for 1 day. He spent the next 2 days sightseeing in Paris and then flew back to New York. The entire trip, including 2 days flying to and from Paris, took 5 days. B would not have made the trip except for the business he had to conduct in Paris. Under present law B can deduct the entire cost of his transportation and food to and from Paris, and the food and lodging attributable to the 1 business day in Paris but not the food and lodging attributable to the 2 days spent on sightseeing. Since the trip did not exceed 1 week, the allocation rules of section 274(c) would not apply.

Example 3.—Taxpayer C flew from New York to Brussels where he spent 14 days on business and 5 days on personal matters and then flew back to New York. The entire trip, including 2 flying days, took 21 days. C would not have made the trip except for the business he had to transact in Brussels. Under present law C could deduct the entire cost attributable to transportation and food to and from Brussels and the food and lodging during the 14 days spent on business but not the food and lodging attributable to the 5 days spent on personal matters. Although the trip exceeded a week the time away from home attributable to nonbusiness activities (5 days out of 21) was less than 25 percent of the total time away from home during the trip. Therefore the allocation rule of section 274(c) does not apply.

(d) *Substantiation required.*—This subsection, except for a clerical change, is identical to subsection (c) of section 274 of the bill as passed by the House. It imposes another limitation on traveling expenses deductible under section 162(a)(2) or 212, on items with respect to activities described in subsection (a) as entertainment, amusement, or recreation, or with respect to facilities used in connection therewith (whether or not excepted from the application of subsec. (a) of sec. 274 by subsec. (e)), and on expenses for gifts. Subsection (d) overrules with respect to the described expenditures the case of *Cohan* v. *Commissioner*, 39 F. 2d 540 (C.A. 2d 1930). That case held that where evidence indicates that a taxpayer has incurred deductible travel or entertainment expenses but their exact amount cannot be determined, the court must make "as close an approximation as it can" and not disallow the deduction entirely. Under subsection (d) approximations of the type which under the *Cohan* doctrine have been sufficient to entitle the taxpayer to a deduction will no longer have that effect. In other words, if the taxpayer fails to substantiate an item as required by subsection (d) and the regulations thereunder, the item will be completely disallowed.

Subsection (d) provides that no deduction is to be allowed for the above-described items unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement the following: the amount of such expense or other item; the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift; the business purpose of the expense or other item; and the business relationship to the taxpayer of the persons entertained, using the facility, or receiving the gift. The taxpayer's records or corroborating evidence, must pertain to separate expenses or other items of deduction, not to aggregate amounts.

Generally, a clear, contemporaneously kept diary, account book, or similar record containing the information specified in subsection (d) will be an adequate record within the meaning of this subsection. However, receipts, canceled checks, paid bills, stubs, or other similar records may be required in certain cases, as, for example, to substantiate the amount expended for lodging and transportation while traveling on business. Thus, the taxpayer may be required to preserve hotel bills or transportation receipts to substantiate such items by adequate records. In order to avoid hardship, a reasonable reconstruction of expenditures will be accepted in those cases where the absence of records is due to circumstances beyond the taxpayer's control, such as destruction by fire, flood, or other casualty.

Where the taxpayer fails to maintain adequate records with respect to any of the described aspects of an expense, that aspect must be substantiated by the taxpayer's own statement corroborated by sufficient evidence. The taxpayer's own uncorroborated statement will not constitute substantiation with respect to any such aspect. The evidence required may vary with respect to each aspect of an item claimed as a deduction. Thus, circumstantial evidence, such as the nature of the business activities of the taxpayer and of the person entertained, may be sufficient to corroborate the taxpayer's statement regarding business purpose and business relationship, whereas more direct evidence, such as the testimony of witnesses, will be required to substantiate amount, time, place, date, and description.

Under subsection (d), the Secretary of the Treasury or his delegate is authorized to provide by regulations that some or all of the requirements of subsection (d) are not to apply in the case of an expense which does not exceed an amount determined under such regulations. Thus, the regulations could provide that a fixed scale of allowance for mileage or per diem in lieu of subsistence, based upon reasonable business practices, will be acceptable in lieu of detailed substantiation. Similarly, the regulations could prescribe an exception for *de-minimis* expenses.

(e) *Exceptions to application of subsection (a).*—Subsection (e) of the new section 274 is identical to subsection (d) of the bill as passed by the House except for clerical changes and an amendment to paragraph (6) discussed below. Subsection (e) contains nine exceptions to the general rule of section 274(a). These exceptions are to the disallowance provision of subsection (a) exclusively. The fact that an item is not covered by one of the nine exceptions does not mean that *ipso facto* it will be disallowed under subsection (a). It is to be emphasized that the new section 274(e) in no way changes existing law with respect to the disallowance of expenses by reason of failure to meet the "ordinary and necessary" test in section 162 or 212 of the code. Furthermore, the substantiation requirements of subsection (d) also must be fulfilled with respect to the items covered by these exceptions.

Paragraph (1) excepts from the disallowance prescribed in subsection (a)(1) expenses for food and beverages furnished under circumstances which are of a type generally considered to be conducive to a business discussion, taking into account the surroundings in which furnished, the taxpayer's trade, business, or income-producing activity, the relationship to such trade, business, or activity of the persons to whom the food and beverages are furnished, and any other relevant facts. There is no requirement in this exception that business actually be discussed. Thus, if the described circumstances are established, and if the amounts are deductible under section 162 or 212 and are substantiated as required under section 274(d), the expenses for food and beverages will be deductible without reference to the "directly related to or associated with" tests of subsection (a)(1). Of course, "trade or business" is not restricted to commercial activities but includes other activities such as teaching, the practice of law or medicine, etc.

Paragraph (2) relates to food and beverages furnished on the taxpayer's business premises. By reason of this exception, no expense for food and beverages furnished on the business premises primarily to employees of the taxpayer will be disallowed under section 274(a). In addition, expenses for food and beverages furnished to nonemployee business guests will be deductible if furnished in a dining room which is primarily for the taxpayer's employees and is located on the taxpayer's business premises. Paragraph (2) also excepts from disallowance expenses for facilities to the extent they are used in connection with furnishing the above-described food and beverages. The exception provided by paragraph (2) applies to both the typical company cafeteria and meals furnished to employees because their presence on the job at all times is essential.

The exception in paragraph (3) applies to expenses for goods, services and facilities to the extent that the expense is properly treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation paid to an employee on the taxpayer's income tax return and as "wages" for purposes of withholding. Thus, a taxpayer rewarding a key employee with a vacation trip would not be disallowed the expenses under section 274(a) if the taxpayer treated the expenses as wages for withholding purposes and deducted them on his income tax return as compensation paid to the key employee. Salary paid to the captain of a yacht used for business entertaining does not come within this exception.

If an expense properly constitutes a dividend to a shareholder, or if it constitutes unreasonable compensation to an officer or employee, the exception in paragraph (3) will not prevent its disallowance.

Paragraph (4) excepts from disallowance with respect to the taxpayer certain expenses paid or incurred by the taxpayer in connection with the performances by him of services for another person (whether or not such other person is the taxpayer's employer) for which the taxpayer is reimbursed by such other person under a reimbursement or other allowance arrangement. This exception prevents the double disallowance of a single expenditure, once with respect to the person who actually bears the expense and benefits from it and once with respect to the person who pays the expense on behalf of the first person and is reimbursed therefor. However, two qualifications are provided which insure that a described expense will be disallowed at one level. If the services are performed by a taxpayer, who is an employee, for his employer, and if the employer treats the expense as compensation paid to the employee and it falls within the scope of the subsection (e)(3) exception, the subsection (e)(4) exception does not apply. If the services are performed by the taxpayer for a person who is not the taxpayer's employer, the subsection (e)(4) exception does not apply unless the taxpayer accounts to such other person by means of records or other sufficient evidence which would satisfy the substantiation requirement of subsection (d). The term "reimbursement or other expense allowance arrangement" is derived from section 62(2)(A) of the code and has the same meaning in section 274(e) (without regard to whether the taxpayer is the employee of the person for whom services are performed) as it does in that section.

Paragraph (5) provides an exception for expenses for recreational, social, or similar activities which are primarily for the benefit of the employees of the taxpayer. This exception applies to the usual employee fringe benefit programs. For example, the expenses of operating a company bowling alley or swimming pool which is available to all employees generally will be deductible. Similarly, the costs of the office Christmas party or summer outing generally will be deductible.

In order to exclude from this exception benefits primarily for executives and owners of closely held businesses, the exception applies only with respect to activities which are primarily for employees other than employees who are officers, shareholders or other owners who own a 10 percent or greater interest in the business, or highly compensated employees. In determining whether an employee owns a 10 percent or greater interest in the business, the employee is to be treated as owning any interest owned by a member of his family (within the meaning of sec. 267(c)(4)).

Paragraph (6) provides an exception for expenses incurred by a taxpayer which are directly related to business meetings of his employees, stockholders, agents, or directors. This paragraph is substantially the same as paragraph (6) of subsection (d) of section 274 in the bill as passed by the House except that whereas the bill as passed by the House was limited to meetings of employees and stockholders, your committee's amendment also includes meetings of agents and directors of the taxpayer. This exception pertains only to meetings which are principally for the discussion of business. To illustrate, a meeting of employees for the principal purpose of introducing them to and instructing them with respect to a new procedure for conducting the employer's business would be considered a business meeting. Similarly, a regular annual meeting of stockholders for the election of directors and discussion of corporate affairs would be considered a business meeting. A convention of employees for the principal purpose of rewarding them for their outstanding performance of services for their employer would not be considered a business meeting. However, such a convention might come within the scope of paragraph (3) or (5).

Paragraph (7) pertains to expenses directly related and necessary to attendance at business meetings or conventions of exempt section 501(c)(6) organizations. It is similar to the exception in paragraph (6), except that it relates only to attendance at meetings, or conventions of business leagues, chambers of commerce, real estate boards, or boards of trade which are exempt from tax under section 501(a).

Paragraph (8) pertains to goods and services (including the use of facilities) which are made available by the taxpayer to the general public. By reason of this exception, expenses for entertainment of the general public by means of television, radio, newspapers, and the like will continue to be deductible under section 162. Similarly, a deduction may still be claimed under section 162 for the expense of maintaining private parks, golf courses, and similar facilities, to the extent that they are available for public use. For example, if a corporation maintained a swimming pool for the use of its executive officers and their guests, but during the summer months made the pool available for a period of time each week to the children participating in the local public recreation program, the portion of the expenses relating to such public use of the pool would come within this exception.

Paragraph (9) is designed to insure that no expense will be disallowed under subsection (a) if it is for goods or services which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth. Thus, the cost of producing nightclub entertainment for sale to customers will not be disallowed. Similarly, the cost of operating a pleasure cruise ship as a business will not be disallowed.

The last sentence in subsection (e) makes it clear that the "expenses" to which paragraphs (1) through (9) relate include such items as depreciation and losses.

(f) *Interest, taxes, casualty losses, etc.*—This subsection, except for a clerical change, is identical to subsection (e) of new section 274 of the bill as passed by the House. Subsection (f) excepts from the provisions of section 274 items which would constitute allowable deductions for an individual taxpayer regardless of whether he was engaged in any trade or business. Examples of such items are interest, taxes such as real property taxes, and casualty losses. Thus, if a taxpayer owned a fishing camp, he could still deduct mortgage interest and real property taxes in full even if its use was not primarily for the furtherance of the taxpayer's trade or business.

(g) *Treatment of entertainment, etc., type facility.*—This subsection, except for a clerical change, is identical to subsection (f) of new section 274 of the bill as passed by the House. This subsection prescribes the treatment to be accorded facilities coming within the purview of subsection (a)(1)(B), for purposes of chapter 1 generally. To the extent that expenses and other items with respect to a facility are disallowed under subsection (a), that portion of the facility is to be accorded the treatment provided under present law to an asset used exclusively for personal, living, and family purposes. Thus, the portion of a facility so treated will not be subject to depreciation, and losses incurred on the sale of such portion will not be deductible.

(h) *Regulatory authority.*—This subsection, except for a clerical change, is identical to subsection (g) of new section 274 of the bill as passed by the House. Subsection (h) authorizes the Secretary of the Treasury or his delegate to prescribe such regulations as he deems necessary to carry out the purposes of section 274. For example, under this authorization rules will be prescribed for determining whether subsection (a) or subsection (b) applies to an expenditure to which both subsections might be considered to apply. Items are to be given the character ascribed to them by the public generally and without regard to the revenue consequences of the characterization.

In addition, the Secretary of the Treasury or his delegate is required to prescribe rules for determining whether section 274 (a) or (b) applies with respect to an expenditure which could also be described as falling solely within the purview of some other section. This overlap problem will be resolved by ascribing to the expenditure a character which carries out the purposes of section 274. If the item confers a personal benefit in the form of entertainment, amusement, recreation, or a personal, living, or family need of the individual it will be treated as a section 274 item.

The problem of the overlap of subsections (a) and (b) of section 274 can be illustrated by a case where a taxpayer provides one of his customers with tickets to an amusement event. Here both the entertainment and gift provisions might apply. Under the regulations the entertainment provision always will apply with respect to such theater tickets regardless of whether the taxpayer accompanies the customer to the theater or sends him the tickets. On the other hand, gifts of a chattel such as a book or a toy will be classified as a gift, coming within the purview of subsection (b), even though the use of the item results in the entertainment of the recipient. Packaged food and beverages will be treated as gifts, while food and beverages consumed at meals will be considered entertainment.

The problem of properly characterizing an expenditure for purposes of determining whether section 274 is applicable, or whether the expenditure is to be treated solely under some other section, can be illustrated by a case where a taxpayer distributes to each of his customers a valuable gift which is inscribed with the taxpayer's name. Expenditures for such items might be characterized as advertising expenses or as expenses for gifts. Under the regulations, expenditures for such items will be characterized as gifts.

SECTION 4. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES (Continued)

(b) *Traveling expenses.*—The House bill amended section 162(a)(2) of the 1954 Code (relating to traveling expenses while away from home) by striking out the existing provision under which the "entire" amount expended for meals and lodging is included in the allowable deduction and would have substituted therefor a provision under which there is to be included a "reasonable" allowance expended for meals and lodging. In lieu of the House provision your committee's amendment provides that the allowable deduction is to include amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances.

(c) *Effective date.*—The House bill provided that the amendments made by section 4 are to apply with respect to taxable years ending after June 30, 1962, but only with respect to periods after such date. Your committee's action makes this provision effective with respect to taxable years ending after December 31, 1962, but only with respect to periods after such date.

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

(a) *Amount distributed.*—Subsection (a) of section 5 of the bill amends section 301(b)(1) (relating to amount distributed to corporate distributees) of the 1954 Code by adding at the end thereof a new subparagraph (C). The general rule in new subparagraph (C) provides that for purposes of section 301 the amount of a distribution of property (other than money) received by a corporate shareholder from a foreign corporation will be the fair market value of such property.

An exception to the general rule is provided in cases where a dividends received deduction is allowable under section 245 with respect to such a distribution. In such a case, to the extent the distribution of such property is out of earnings and profits described in section 245(a) (1) and (2), the amount to be taken into account (for purposes of sec. 301 of the code) with respect to property other than money is the sum, determined under regulations prescribed by the Secretary of the Treasury or his delegate, of the amounts computed under subparagraphs (C)(i) and (C)(ii). The amount under subparagraph (C)(i) is that proportion of the lesser of—

(1) the fair market value of such property, or

(2) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property,

which is properly attributable to gross income from sources within the United States. The amount under subparagraph (C)(ii) is that proportion of the fair market value of such property which is properly attributable to gross income from sources without the United States.

The application of subparagraph (C) may be illustrated by the following example involving corporation X, a domestic corporation which owns 100 percent of the outstanding stock of corporation Y, a foreign corporation. Corporation Y, which makes its return on the basis of the calendar year, has earnings and profits of $200,000 for 1963 and derives 60 percent of its gross income from sources within the United States during 1963. For an uninterrupted period of 36 months ending with the close of 1963, corporation Y has been engaged in trade or business within the United States and has derived 50 percent or more of its gross income from sources within the United States. Assume that the only distribution made by corporation Y during 1963 is a distribution of property which has a fair market value of $100,000 and an adjusted basis (in the hands of the distributing corporation immediately before the distribution) of $40,000. The amount of the distribution of such property as determined under section 301(b)(1)(C) is $64,000, computed as follows:

(1) Amount computed under section 301(b)(1)(C)(i): That proportion of the adjusted basis of such property (since it is less than the fair market value) which is properly attributable to gross income from sources within the United States, that is, adjusted basis multiplied by the ratio which gross income from sources within the United States bears to gross income from all sources. $40,000×60 percent	$24,000
(2) Amount computed under section 301(b)(1)(C)(ii): That proportion of the fair market value of such property which is properly attributable to gross income from sources without the United States, that is, fair market value multiplied by the ratio which gross income from sources without the United States bears to gross income from all sources. $100,000×40 percent	40,000
(3) Amount of distribution of property for purposes of section 301	64,000

(b) *Basis.*—Subsection (b) of section 5 of the bill amends section 301(d) of the code (relating to basis of property) by adding a new paragraph (3). The new paragraph (3) provides that where the amount of a distribution of property other than money is determined in accordance with the provisions of subparagraph (C) of section 301(b)(1), the basis of such property shall be the amount of the property distribution. Thus, in the above example the property distributed would have a basis in the hands of corporation X, the distributee, of $64,000, the amount of the distribution.

(c) *Dividends received from certain foreign corporations.*—Paragraph (1) of subsection (c) of section 5 of the bill amends section 245 of the 1954 Code (relating to dividends received from certain foreign corporations) by adding a new subsection (b). The new subsection (b) provides that for purposes of computing the dividends received deduction under section 245(a) the amount of any distribution of property other than money shall be determined under section 301 (b)(1)(B). Under section 301(b)(1)(B) the amount of a distribution of property to a corporate shareholder is the lesser of (1) the fair market value of such property, or (2) the adjusted basis of such property (in the hands of the distributing corporation immediately before the distribution). Thus, for purposes of section 245, the amount of the dividend in the above example would be $40,000, rather than $64,000, and the amount allowed as a deduction under section 245 would be $20,400 ($40,000×60 percent×85 percent).

Paragraph (2) of subsection (c) of section 5 of the bill amends section 245 of the 1954 Code so as to designate the existing text as subsection (a) of section 245.

Subsection (d) of section 5 of the House bill, which provides that the section 301(b)(1)(B) amount of a distribution of property other than money is to be used in computing the credit for foreign taxes under section 902, has been deleted. Therefore, the section 301(b)(1)(C) amount will be used in this respect.

(d) *Effective date.*—Subsection (d) of section 5 of the bill, identical with subsection (e) of such section of the bill as passed by the House, provides that the amendments made by section 5 of the bill shall apply to distributions made after December 31, 1962.

SECTION 6. MUTUAL SAVINGS BANKS, ETC.

(a) *In general.*—Subsection (a) of section 6 of the bill as reported, which corresponds to section 8 of the bill as passed by the House, amends section 593 of the 1954 Code to provide a new method for calculating the deduction for additions to bad debt reserves allowable to the mutual savings banks, domestic building and loan associations, and cooperative banks, referred to in section 593(a) (all of which are hereinafter referred to as mutual savings institutions).

SECTION 593. RESERVES FOR LOSSES ON LOANS

(a) *Organizations to which section applies.*—Subsection (a) of section 593, as amended by the bill, provides that section 593 is to 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. This description of the organizations to which the amended section 593 applies is substantially the same as that contained in section 593 of existing law, and no substantive change is made by this change in description. As is noted below, however, section 7701(a)(19) (definition of domestic building and loan association) was amended by section 8(c) of the bill as passed by the House, and section 6(c) of the bill as reported by your committee further amends such section.

(b) *Additions to reserves for bad debts.*—Subsection (b)(1) prescribes the method for determining the reasonable addition for the taxable year to the reserve for bad debts under section 166(c), and also specifies the reserves to which such additions shall be made. Such reasonable addition is the sum of two amounts—(1) the amount added to the reserve for losses on nonqualifying loans, and (2) the amount added to the reserve for losses on qualifying real property loans.

The first amount is that determined under section 166(c) to be a reasonable addition to the reserve for losses on nonqualifying loans. Nonqualifying loans are defined in subsection (e)(2), and (with certain exceptions) are loans other than loans secured by an interest in improved real property.

The second amount is the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans. Qualifying real property loans are defined in subsection (e)(1) and (with certain exceptions) are loans secured by an interest in improved real property. Under the bill as passed by the House, the amount of the reasonable addition to the reserve for losses on such loans could not exceed the amount determined under one of three different methods described in paragraphs (2), (3), and (4) of subsection (b), whichever method produced the largest amount.

Your committee has amended subsection (b)(1) to provide that the amount of the addition for a taxable year to the reserve for losses on qualifying real property loans, when added to the amount of the addition to the reserve for losses on nonqualifying loans, shall in no case be greater than the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof attributable to the period before the first taxable year beginning after December 31, 1951).

Percentage of taxable income method

This method is described in subsection (b)(2). Under the bill as passed by the House the amount of the reasonable addition to the reserve for losses on qualifying real property loans for a taxable year was limited to the excess of an amount equal to 60 percent of the taxable income for such year over the amount determined under section 166(c) to be a reasonable addition to the reserve for losses on nonqualifying loans. For purposes of this method, taxable income is determined without regard to any deduction under section 166(c) for any additions to the reserves for bad debts, and also by excluding from gross income any amount included therein by reason of subsection (f) (relating to the treatment of certain distributions of property to stockholders by a domestic building and loan association).

Your committee has made two amendments to subsection (b)(2). The first amends subparagraph (A) of subsection (b)(2) to provide that the amount computed under that subparagraph shall be an amount equal to 50 percent of taxable income for the taxable year (rather than 60 percent) in the case of a taxpayer which is a domestic building and loan association having capital stock with respect to which any distribution of property (as defined in sec. 317(a)) is not allowable as a deduction under section 591. In the case of a mutual savings institution other than one described in the preceding sentence the percentage figure remains at 60 percent.

Your committee's second amendment to subsection (b)(2) provides that the amount of the addition determined thereunder shall not exceed such amount as is necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to 6 percent of such loans outstanding at such time.

Percentage of real property loans method

Under this method, which is described in subsection (b)(3) and which has been amended by your committee to provide a special deduction for certain new companies, the amount of the reasonable addition to the reserve for losses on qualifying real property loans is limited to the amount necessary to increase the balance (as of the close of the taxable year) of such reserve to an amount equal to the amount described in subparagraph (A) or equal to the sum of two amounts which are described in subparagraphs (A) and (B) of such subsection. The first amount, which applies in the case of all mutual savings institutions, is an amount equal to 3 percent of qualifying real property loans outstanding at the close of the taxable year. The second amount applies only to a mutual savings institution which is a "new company" and which does not have capital stock with respect to which distributions of property (as defined in sec. 317(a)) are not allowable as a deduction under section 591. In the case of such an institution, such second amount is equal to (i) 2 percent of such loans outstanding, or 2 percent of $4 million, whichever is the lesser, reduced (but not below zero) by (ii) the amount, if any, of the balance (as of the close of the year) of the taxpayer's supplemental reserve for losses on loans. For purposes of computing such second amount, a mutual savings institution qualifies as a "new company" for any taxable year only if such taxable year begins not more than 10 years after the first day on which it (or any predecessor) was authorized to do business as an organization described in section 593(a).

Experience method

Under this method, described in subsection (b)(4), the amount of the reasonable addition to the reserve for qualifying real property loans is limited to the amount determined under section 166(c) (without regard to sec. 593(b)) to be a reasonable addition to such reserve.

(c) *Treatment of reserves for bad debts.*—Subsection (c)(1) of section 593 as amended provides that each mutual savings institution which uses the reserve method of accounting for bad debts is to 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. Except as provided in the last sentence of paragraph (5) of this subsection, which is a new paragraph added by your committee, such reserves are to be treated for all purposes as reserves for bad debts. Thus, although these reserves are termed reserves for "losses," they are reserves for bad debts; and any charge to any such reserve for an item other than a bad debt will result in the inclusion in gross income of an amount equal to such charge. As is indicated below, however, any portion of the reserve for losses on qualifying real property loans which represents amounts allocated thereto pursuant to subsection (c)(5) shall not be treated as a reserve for bad debts for any purpose other than the determination of the amount deductible under subsection (b).

Allocation of pre-1963 reserves

Paragraphs (2) and (3) of subsection (c) prescribe rules governing the method of allocating pre-1963 reserves among the three reserves described above. The term "pre-1963 reserves" is defined by paragraph (4) to mean the net amount, determined as of the close of December 31, 1962 (after applying the provisions of subsec. (d)(1) relating to taxable years beginning in 1962 and ending in 1963), accumulated in the reserve for bad debts pursuant to section 166(c) (or the corresponding provisions of prior revenue laws), whether or not determined with reference to section 593, for taxable years beginning after December 31, 1951.

Paragraph (2) of subsection (c) provides that such pre-1963 reserves shall, as of the close of December 31, 1962, be allocated to, and constitute the opening balances of, the reserve for losses on nonqualifying loans, the reserve for losses on qualifying real property loans, and the supplemental reserve for losses on loans.

Paragraph (3) of subsection (c) provides that the pre-1963 reserves shall be allocated first to the reserve for losses on nonqualifying loans to the extent that such reserve is not increased above the amount which would constitute a reasonable addition under section 166(c) for a period in which such nonqualifying loans increased from zero to the amount thereof outstanding at the close of December 31, 1962. Thus, the pre-1963 reserves will be allocated to the reserve for losses on nonqualifying loans in an amount not in excess of the maximum amount (determined without regard to any annual limitation which might be imposed under sec. 166(c) on building such reserve to its full amount) which could have been added, as of the close of 1962, to such reserve under subsection (b)(1)(A) if the balance of such reserve immediately prior to such addition had been zero. The remaining portion of the pre-1963 reserves is then allocated to the reserve for losses on qualifying real property loans to the extent such reserve is not increased above the larger of two amounts. The first amount is the amount which would be determined under paragraph (3)(A) of subsection (b) as being necessary to increase the balance of the reserve from zero to 3 percent of qualifying real property loans outstanding at the close of December 31, 1962. The second amount is the amount which would be determined under section 166(c) (without regard to sec. 593) to be a reasonable addition to the reserve for losses on qualifying real property loans for a period in which such loans increased from zero to the amount thereof outstanding at the close of December 31, 1962. Any remaining balance of the pre-1963 reserves is allocated to the supplemental reserve for losses on loans.

Paragraph (5) of subsection (c) is a new provision which your committee has added to the bill. This paragraph provides that if, after the allocation of pre-1963 reserves to the reserves for losses on nonqualifying loans and for losses on qualifying real property loans, the opening balance of the reserve for losses on qualifying real property loans is less than the maximum amount prescribed by paragraph (3)(B), then, for purposes of subsection (c), the term "pre-1963 reserves" shall also include so much of the taxpayer's "pre-1952 surplus" as does not exceed the amount by which such opening balance is less than the amount described in such paragraph (3)(B). As used in the preceding sentence the term "pre-1952 surplus" refers to the taxpayer's surplus, undivided profits, and bad debt reserves determined as of December 31, 1962, and attributable to the period before the first taxable year beginning after December 31, 1951, but does not include any portion thereof attributable to interest which would have been excludable from gross income under section 22(b)(4) of the Internal Revenue Code of 1939 (relating to interest on governmental obligations) or the corresponding provisions of prior revenue laws.

Paragraph (5) also provides that, notwithstanding the second sentence of paragraph (1) (which requires that the three reserves established pursuant to subsec. (c) shall be treated as reserves for bad debts), any portion of the pre-1952 surplus included in the reserve for losses on qualifying real property loans shall not be treated as a reserve for bad debts for any purpose other than determining the amount of the addition to the reserve for losses on qualifying real property loans, and for such purpose such portion shall be treated as remaining in such reserve. Thus, such portion of the pre-1952 surplus as is included in the reserve for losses on qualifying real property loans as of the close of December 31, 1962, shall be deemed to be included in the balance of such reserve as of the close of each taxable year to which the amended section 593 applies, but only for the limited purpose of determining the maximum permissible addition to such reserve under subsection (b). For all other purposes such portion of the pre-1952 surplus will retain the character that it has under existing law. The effect of your committee's addition of paragraph (5) to subsection (c) is to place an institution which accumulated most of its reserves and surplus prior to 1952 on the same basis, for purposes of computing future additions to reserves, as an institution which accumulated most of its reserves after 1951.

Subsection (c)(6), which is identical to subsection (c)(5) of section 593 in the bill as passed by the House, provides that 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.*—Subsection (d) of the amended section 593 contains provisions for the computation of taxable income in the case of a taxable year which is a fiscal year beginning in 1962 and ending in 1963. With certain exceptions, the general effective date provision in section 6(g)(1) of the bill makes the amended section 593 applicable with respect to taxable years ending after December 31, 1962. However, subsection (d) makes section 593 take effect with respect to fiscal year taxpayers as of January 1, 1963. Subsection (d) apportions taxable income for the entire taxable year (determined without regard to any deduction under sec. 166(c)) between the part of the taxable year which falls in 1962 and the part which falls in 1963. Such taxable income is allocated to each part year on the basis of the ratio which the number of days in each such part year bears to the number of days in the entire taxable year. The portion of such taxable income allocable to the part of the year occurring before January 1, 1963, is then reduced under subsection (d)(1) by an amount equal to the deduction which would have been allowable under section 166(c) for an addition to the reserve for bad debts as if such part year constituted a taxable year and as if section 593, as in effect before the amendments made by section 6 of the bill, applied. The portion of such taxable income allocable to the part of the taxable year occurring after December 31, 1962, is reduced, under subsection (d)(2), by an amount equal to 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 sec. 6 of the bill) if such part year constituted a taxable year. The amounts of taxable income thus obtained for each part year are then added to obtain the taxable income for the entire taxable year.

The amount of the deduction allowable for the pre-1963 part year to a mutual savings institution under subsection (d)(1) is limited, by reason of section 593(2) of existing law, to the amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such part year (Dec. 31, 1962) exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year. In addition, by reason of section 593(1) of existing law, the deduction allowable under subsection (d)(1) for the pre-1963 part year to a mutual savings institution cannot exceed the amount of its taxable income (determined without regard to any deduction under sec. 166) allocable to the pre-1963 part year. Although the amount of the deduction allowable for the pre-1963 part year under subsection (d)(1) cannot be determined until the close of the entire taxable year (by reason of the taxable income limitation and because the amount must be reflected on the institution's regular books of account), this amount is added to the institution's pre-1963 reserves. The pre-1963 reserves are then allocated under the rules of subsection (c), as of the close of December 31, 1962, by reference to the amount of nonqualifying loans and qualifying real property loans outstanding at that time.

The deduction referred to in subsection (d)(2) for the post-1962 part year is determined under subsection (b) and is equal to the sum of the amount of an addition to the reserve for losses on nonqualifying loans plus the amount of an addition to the reserve for qualifying real property loans. The amount of the addition to the reserve for nonqualifying loans is computed by reference to the amount of such loans outstanding at the close of the taxable year in relation to the balance in the reserve for such loans at that time. The amount of the addition to the reserve for qualifying real property loans, if determined under the percentage of taxable income method, would be equal to the excess of an amount equal to 60 percent (or 50 percent, as the case may be) of the taxable income (determined under subsec. (b)(2)) which is allocable to the post-1962 part year over the amount of the reasonable addition to the reserve for nonqualifying loans. If the addition to the reserve for qualifying real property loans is determined under the percentage of real property loans method or the experience method, it would be computed by reference to the amount of such loans outstanding at the close of the taxable year in relation to the balance in the reserve for such loans at that time.

(e) *Loans defined.*—Subsection (e) of the amended section 593 defines, for purposes of that section, the terms "qualifying real property loans", "nonqualifying loans", and "loans".

The term "loan" is defined to mean debt, as the term "debt" is used in section 166. Since subsection (c) of section 166 is made inapplicable by section 582(a) in the case of a mutual savings institution, the term "loan" includes a debt evidenced by a security as defined in section 165(g)(2)(C). For purposes of subsection (e), a taxpayer will be considered to have made a loan to the extent of his participation in the loan, whether the loan was made by him or by another person.

Under paragraph (1) of subsection (e), a "qualifying real property loan" is defined to mean any loan of the taxpayer which is secured by an interest in improved real property unless such loan is described in subparagraph (A), (B), (C), or (D) of such paragraph. The loans described in these subparagraphs are: (A) any loan evidenced by a security (as defined in sec. 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 a government or political subdivision or instrumentality thereof, a bank as defined in section 581, or another member of the same affiliated group; (C) any loan to the extent secured by a deposit in or share of the taxpayer; and (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 by the taxpayer to be for bona fide business purposes.

The term "affiliated group" is defined as having the meaning assigned to such term by section 1504(a) of existing law; except that (1) the phrase "more than 50%" shall be substituted for the phrase "at least 80%" each place it appears in section 1504(a), and (2) all corporations shall be treated as includible corporations (without any exclusion under sec. 1504(b)).

Paragraph (2) of subsection (e) defines the term "nonqualifying loan" as any loan of the taxpayer which is not a qualifying real property loan as defined by the bill. Thus, a loan which is, for example, evidenced by a security as defined in section 165(g)(2)(C), is treated as a nonqualifying loan irrespective of the fact that it may be secured by improved real property.

(f) *Distributions to shareholders.*—Subsection (f) of the amended section 593 prescribes rules governing certain distributions of property (as defined in sec. 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. The term "distribution" is defined to include any distribution in redemption of stock or in partial or complete liquidation of the association, as well as dividend distributions as defined in section 316(a).

Paragraph (1) of subsection (f) provides, in general, that a distribution with respect to its capital stock is to be treated as made, first, out of the association's earnings and profits accumulated in taxable years beginning after December 31, 1951 (to the extent thereof); second, out of the reserve for losses on qualifying real property loans, to the extent the additions to such reserve exceed the additions which would have been allowed under the experience method described in subsection (b)(4); third, out of the supplemental reserve for losses on loans (to the extent thereof); and, finally, out of such other accounts as may be proper. The foregoing order of charging applies to all subsection (f) distributions other than those in redemption of stock or in partial or complete liquidation of the association. In these latter situations the distribution is treated as made, first, out of the reserve for losses on qualifying real property loans to the extent the additions to such reserve exceed the additions which would have been allowed under the experience method described in subsection (b)(4); second, out of the supplemental reserve (to the extent thereof); third, out of earnings and profits accumulated in taxable years beginning after December 31, 1951 (to the extent thereof); and, finally, out of other appropriate accounts. In determining the portion of the reserve for losses on qualifying real property loans out of which a distribution described in subsection (f)(1) is treated as made, the word "additions," as used in subparagraph (B) of subsection (f)(1), includes both the additions made to such reserve under subsection (b)(1)(B) and the amount of the pre-1963 reserves allocated thereto pursuant to subsection (c)(3). In computing the amount of the additions which would have been allowed under the experience method, the amount of the pre-1963 reserves initially allocated, and the subsequent additions, to the reserve for losses on qualifying real property loans shall be computed solely by reference to the experience method.

Paragraph (2) of subsection (f) provides that, if a distribution described in paragraph (1) is treated as having been made out of the reserve for losses on qualifying real property loans or out of the supplemental reserve for losses on loans, the amount charged against such reserve shall be the amount which, when reduced by the amount of Federal income tax attributable to the inclusion of such amount in gross income, is equal to the amount of such distribution. Any amount so charged against such reserve shall be included in the gross income of the distributor association. Since the amount so included in gross income is also included in earnings and profits, the effect of subsection (f) is to treat such amount as having been first transferred from the reserves to earnings and profits and then charged to earnings and profits. Thus, this rule will normally insure that there will be earnings and profits sufficient to make distributions which are in reality dividends taxable as such, even though the association has previously deducted, in computing its earnings and profits, the amount of additions to its bad debt reserves. However, apart from the consequences which flow from the fact that earnings and profits will be created by such charges to the reserves, income tax consequences to stockholders are not otherwise affected by subsection (f).

Paragraph (3) of subsection (f) provides special rules. Subparagraph (A) provides that, for purposes of treating a distribution as having been made out of the reserve for losses on qualifying real property loans, additions to such reserve for the taxable year in which the distribution occurs shall be taken into account. Thus, the amount of such reserve will be augmented by the addition to such reserve computed under subsection (b) before the reserve is reduced by reason of treating a distribution as having been made out of the reserve. Subparagraph (B) provides that, for purposes of computing (under sec. 593, as amended by the bill) 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) of subsection (f) shall not be taken into account. Thus, the amount by which such reserve is reduced by reason of distributions to stockholders cannot serve as the basis for subsequent deductible additions to such reserve.

SECTION 6. MUTUAL SAVINGS BANKS, ETC. (Continued)

(b) *Foreclosure on property securing loans.*—Subsection (b) of section 6 adds a new section 595 to the code. The section applies only to a creditor which is a mutual savings institution described in the amended section 593(a).

Nonrecognition of gain or loss as a result of foreclosure

Subsection (a) of the new section 595 provides that 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.

Character of property

Subsection (b) of the new section 595 provides that, for purposes of sections 166 (relating to the deduction for bad debts) and 1221 (relating to the definition of a capital asset), any property acquired in a transaction with respect to which gain or loss was not recognized to the creditor by reason of subsection (a) shall be considered as property having the same characteristics as the indebtedness for which such property was security. The subsection further provides that any amount realized by such creditor with respect to such property shall be treated (for purposes of ch. 1 of the code) as a payment on account of such indebtedness, and that any loss with respect to such property shall be treated as a bad debt to which the provisions of section 166 apply.

Basis

Subsection (c) of the new section 595 provides that the basis of any property acquired in a transaction 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 any costs of acquisition.

Regulatory authority

Subsection (d) of the new section 595 provides that the Secretary of the Treasury or his delegate shall prescribe such regulations as he may deem necessary to carry out the purposes of this section.

(c) *Definition of a domestic building and loan association.*—Subsection (c) of section 6 amends section 7701(a)(19) of the code to provide a new definition of the term "domestic building and loan association." As amended by your committee, paragraph (19) of section 7701(a) defines this term to mean any domestic building and loan association, domestic savings and loan association, or Federal savings and loan association, which meets each of the requirements prescribed by subparagraphs (A) through (E) of such paragraph. For purposes of convenience, such associations are hereinafter referred to as "domestic savings associations."

Subparagraph (A) of paragraph (19) provides that the domestic savings association must be either an insured institution within the meaning of section 401(a) of the National Housing Act (12 U.S.C., sec. 1724(a)), or subject by law to supervision or examination by State or Federal authority having supervision over such associations. The "insured institutions" referred to are those the accounts of which are insured by the Federal Savings and Loan Insurance Corporation.

Subparagraph (B) thereof requires that substantially all the business of the domestic savings association consist of acquiring the savings of the public and investing in loans described in subparagraph (C). Thus, even though such an association otherwise meets the asset requirements imposed by subparagraphs (C), (D), (E), and (F) of paragraph (19), it will nevertheless not qualify as a domestic building and loan association if more than an insubstantial portion of its business consists of, for example, mortgage or insurance brokerage activities.

Subparagraph (C) of paragraph (19) requires that at least 90 percent of the amount of the total assets of a domestic savings association must consist of (i) cash (including time or demand deposits with, or withdrawable accounts in, other financial institutions), (ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States, or of a State or political subdivision thereof, (iii) loans secured by an interest in real property and loans made for the improvement of real property, (iv) loans secured by a deposit or share of a member of such association, and (v) property acquired through the liquidation of defaulted loans which are secured by an interest in real property or which are made for the improvement of such property. In determining whether the percentage requirements imposed by paragraph (19) are met, the amount of each item included in the amount of total assets of a domestic savings association shall be measured by the adjusted basis of such item, as determined under section 1011 (relating to the adjusted basis for determining gain or loss), or by such other method as is in accordance with sound accounting principles.

Subparagraph (D) of paragraph (19) provides that, of the assets which are taken into account by the taxpayer under subparagraph (C) as assets constituting the 90 percent of total assets, at least 80 percent of such 90 percent must consist of (1) cash and governmental obligations described in clauses (i) and (ii) of subparagraph (C), and (2) loans secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property, or of loans which are made for the improvement of such residential real property. Subparagraph (D) further provides that at least 70 percent of such 90 percent must consist of (1) cash and governmental obligations described in clauses (i) and (ii) of subparagraph (C), and (2) loans secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property containing four or fewer family units, or of loans made for the improvement of residential real property containing four of fewer family units.

Subparagraph (E) of paragraph (19) provides that not more than 18 percent of the total assets of the taxpayer may consist of assets other than those described in clause (i) of subparagraph (D) (cash, certain Government obligations, and loans secured by an interest in improved residential real property); and not more than 27 percent of the total assets of the taxpayer may consist of assets other than those described in clause (ii) of subparagraph (D) (cash, certain Government obligations, and loans secured by one- to four-family residential real property). However, the 18- and 27-percent limitations contained in this subparagraph shall be increased by the number, if any, of percentage points (including any fraction of a percentage point) by which 10 percent exceeds the percentage of the total assets consisting of assets described in clauses (i) and (ii) of subparagraph (C) (cash and certain governmental obligations). Thus, a mutual savings institution may not have more than 18 percent of its total assets in commercial loans, nor more than 27 percent of its total assets in commercial loans and loans secured by apartment buildings, except to the extent its cash and governmental obligations constitute less than 10 percent of its assets.

Subparagraph (F) of paragraph (19) provides that none of the assets of a domestic savings association may be invested in the stock of any corporation, other than stock of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof, stock acquired through the liquidation of a defaulted loan which was secured by an interest in real property or made for the improvement of real property, or stock representing a withdrawable account in another financial institution.

(d) *Clerical amendments.*—Subsection (d) of section 6 contains clerical amendments.

(e) *Repeal of exemption from certain excise taxes.*—Under section 5(h) of the Home Owner's Loan Act of 1933 (48 Stat. 132; 12 U.S.C., sec. 1464(h)), Federal savings and loan associations are exempted from Federal taxes other than payroll taxes and income, war profits, and excess profits taxes, the legal incidence of which would fall upon such associations. Thus, under existing law Federal savings and loan associations are not subject to the excise taxes which sections 4251 and 4261 of the code impose, respectively, on communications and the transportation of persons. Subsection (d) of this section of the bill as passed by the House eliminated the exemption which section 5(h) of the Home Owner's Loan Act accorded those associations with respect to the taxes imposed by sections 4251 and 4261. Paragraph (1) of subsection (e) of this section of the bill, as reported by your committee, amends section 5(h) of the Home Owner's Loan Act so as to eliminate entirely the exemption from Federal taxes which that section now provides in the case of Federal savings and loan associations.

Under section 4382(a)(2) of the code, capital stock and certificates of indebtedness issued by domestic building and loan associations (as defined in sec. 7701(a)(19)) and cooperative banks are exempt from the documentary stamp taxes imposed by chapter 34 of the code. Your committee has added a new paragraph (2) to section 6(e) of the bill which eliminates this exemption insofar as it extends (i) to all certificates of indebtedness (as defined in sec. 4381(a)) issued by a domestic building and loan association or cooperative bank, and (ii) to shares or certificates of stock issued by such a domestic building and loan association or cooperative bank with respect to which any distribution of property (as defined in sec. 317(a)) is not allowable as a deduction under section 591. Thus, your committee's amendment of section 4382(a)(2) continues the exemption which that section provides in the case of shares or certificates of stock issued by such associations or banks and representing deposits or withdrawable accounts, as well as the exemption which it provides in the case of all shares or certificates of stock and certificates of indebtedness issued by mutual ditch or irrigation companies. As used in section 6(e)(2) of the bill, the term "domestic building and loan association" includes homestead associations which qualify under the amended definition of domestic building and loan associations contained in section 6(c) of the bill.

(f) *Deduction for dividends or interest paid on deposits.*—Subsection (f) of section 6 of the bill, which has been added by your committee, amends section 591 of existing law by providing that—in addition to mutual savings banks, cooperative banks, and domestic building and loan associations—savings institutions chartered and supervised as savings and loan associations or similar associations under Federal or State law shall be allowed as a deduction in computing taxable income amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw. Thus, even though an association chartered and supervised as a savings and loan or similar association under Federal or State law may not qualify as a domestic building and loan association as defined in section 7701 (a)(19), as amended, your committee's amendment will insure the deductibility of dividends or interest paid on such withdrawable accounts or deposits.

(g) *Effective dates.*—Subsection (g) of section 6 of the bill provides effective dates for subsections (a), (b), (c), and (e) of section 6 of the bill.

Paragraph (1) of section 6(g) of the bill provides that the amendments made by section 6(a) of the bill (which amends sec. 593 of existing law) shall apply to taxable years ending after December 31, 1962, except that section 593(f) of the code shall apply to distributions made after December 31, 1962, in taxable years ending after such date.

Paragraph (2) of section 6(g) of the bill provides that the amendments made by section 6(b) of the bill (which adds a new sec. 595) shall apply to transactions described in section 595(a) of the code occurring after December 31, 1962, in taxable years ending after such date.

Paragraph (3) of section 6(g) of the bill provides that the amendment made by section 6(c) of the bill (which amends section 7701(a)(19) of existing law) shall apply to taxable years beginning after the date of the enactment of the bill.

Paragraph (4) of section 6(g) of the bill, as amended by your committee, provides that subsection (e) of the bill shall become effective on January 1, 1963, except that, in the case of the tax imposed by section 4251 of the code, subsection (e) shall apply only with respect to amounts paid pursuant to bills rendered after December 31, 1962; and, in the case of the tax imposed by section 4261 of the code, subsection (e) shall apply only with respect to transportation beginning after December 31, 1962.

SECTION 7. DISTRIBUTIONS BY FOREIGN TRUSTS

This section is the same as section 9 of the bill as passed by the House, with two exceptions. First, your committee has changed the definition of the term "foreign trust created by a U.S. person" so that a foreign trust will come within the definition only to the extent of money or property (including accumulated earnings therefrom) transferred to the trust by a U.S. person or under the will of a U.S. citizen or resident. Second, a change has also been made in the effective date provision to provide that the amendments made by the bill shall apply to distributions made after the date of enactment of the bill.

(a) *Definitions.*—Section 7(a) of the bill amends section 643 of the 1954 Code (definitions relating to the income of estates and trusts) in the following respects:

Modification of distributable net income.—Section 7(a)(1) of the bill amends section 643(a) (relating to modifications taken into account in computing distributable net income) in two respects. First, a new subparagraph (B) is added to section 643(a)(6) to provide that the gross income of a foreign trust from sources within the United States is to be determined without regard to section 894 (relating to income exempt under treaty). A further amendment is made to section 643(a)(6) by the addition of a new subparagraph (C). The new section 643(a)(6)(C) provides that section 643(a)(3) (relating to capital gains and losses) is not to apply to a "foreign trust created by a U.S. person," as defined in section 643(d). In lieu of the rules provided by section 643(a)(3), the new subparagraph (C) provides that there is to be included in distributable net income 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 exchanges. The new subparagraph (C) also provides that the deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) is not to be taken into account. Existing section 643(a)(3) will continue to apply to trusts other than foreign trusts created by U.S. persons.

Foreign trusts created by U.S. persons

Section 7(a)(2) of the bill adds a new subsection (d) to section 643 of the 1954 Code. The new section 643(d) provides that, for purposes of part I of subchapter J (relating to estates, trusts, and beneficiaries), the term "foreign trust created by a U.S. person" means the portion of a foreign trust (as defined in sec. 7701(a)(31)) attributable to money or property transferred to it directly or indirectly by a U.S. person (as defined in sec. 7701(a)(30)), or under the will of a decedent who at the date of his death was a U.S. citizen or resident, and including all accumulated earnings, profits, or gains attributable to such money or property. A foreign trust, created by a person who is not a U.S. person, to which a U.S. person transfers money or property would under this definition be in part a foreign trust created by a U.S. person.

(b), (c), and (d) *Modification of throwback.*—Subsections (b) through (d) of section 7 of the bill make various amendments designed to modify the so-called throwback provisions of the code in their application to certain foreign trusts.

Existing law

Under existing law the so-called throwback provisions of subchapter J operate substantially as follows: When a beneficiary receives as a distribution an amount in excess of current distributable net income, and the distribution exceeds $2,000, it is called an accumulation distribution. The beneficiary is taxed on this amount to the extent there was undistributed net income of the trust in any of the preceding 5 years, the undistributed net income of such prior years being taken into account in inverse order. Undistributed net income consists of undistributed distributable net income for a taxable year, minus the taxes on the trust attributable to such undistributed amount. The beneficiary is also required to include in gross income an appropriate portion of the U.S. income taxes, if any, imposed on the trust with respect to the undistributed net income, but he receives a tax credit based on the taxes the trust would not have had to pay if the undistributed distributable net income had actually been paid to the beneficiary.

Although under section 668(a) the beneficiary is taxable currently on the entire distribution, as well as on the taxes on the trust allocable to that amount, the tax attributable to the distribution cannot exceed the tax he would have paid had the distribution been paid to him on the last day of each of the preceding taxable years to the extent the undistributed net income of each of those years is considered absorbed by the distribution. The taxes deemed distributed to him are similarly spread back.

Under existing law, however, as noted, the throwback rule does not operate with respect to distributions made out of accumulations for taxable years before the fifth year preceding the taxable year. In addition, there are certain exceptions to what may be taken into account in determining whether there has been an accumulation distribution, e.g., a distribution out of accumulations for a minor, or a final distribution of the trust made to a beneficiary more than 9 years after the date of the last transfer to the trust.

Modification of accumulation distribution

Section 7(b)(1) of the bill amends section 665(b) (relating to the definition of accumulation distribution) to limit the application of such definition to trusts other than foreign trusts created by U.S. persons. A new section 665(c), added by section 7(b)(2) of the bill, provides a definition of accumulation distribution for foreign trusts created by U.S. persons. Under this new definition, a distribution in excess of current distributable net income constitutes an accumulation distribution whether or not the distribution exceeds $2,000. In addition, there are no exceptions to what is taken into account in determining whether there has been an accumulation distribution. Thus, any distribution in excess of current distributable net income will, under the new section 665(c), be an accumulation distribution.

The last sentence of section 665(c) provides that any amount paid to a U.S. person which is from a payor who is not a U.S. person, and which is derived directly or indirectly from a foreign trust created by a U.S. person, is to be deemed in the year of payment to have been directly paid by the foreign trust. Thus, if a nonresident alien receives a distribution from a foreign trust created by a U.S. person and he then pays the amount of the distribution over to a U.S. person, the payment of such amount to the U.S. person represents an accumulation distribution to the U.S. person from such trust, to the extent that the amount received would have been an accumulation distribution had the trust paid the amount directly to the U.S. person. An example of a payment indirectly derived by a nonresident alien from such a foreign trust would be where the trust distributes to a foreign trust which was not created by a U.S. person, and which latter foreign trust makes a distribution to the nonresident alien. In this case, the payment over to a U.S. person is considered to have been made from the initial and not from the intervening trust. The same result would obtain if the intervening trust were a foreign trust created by a U.S. person. However, even if a payment is made to a U.S. person by a person who is not a U.S. person and who directly or indirectly derived the amount paid from a foreign trust created by a U.S. person, the receipt of the amount by the U.S. person is not considered the receipt of an accumulation distribution from a trust if the amount is received under circumstances indicating lack of intent on the part of the parties to circumvent the purposes of section 7 of the bill.

Other modifications of the throwback rule

The restriction of the throwback rule to the 5 preceding taxable years of the trust is removed by section 7(c)(2) of the bill for foreign trusts created by a U.S. person. However, this unlimited throwback will operate only for years governed by the 1954 Code.

Section 7(d) of the bill adds a new sentence to section 668(a) (relating to amounts treated as received in prior taxable years). In the case of a U.S. person who is a beneficiary of a foreign trust created by a U.S. person, this sentence conditions the availability of the limitation on tax provided by section 668(a) on a beneficiary's meeting the information requirements of new section 669(b), added by section 7(e) of the bill.

The provisions of subchapter J which remain unchanged by the bill will continue to apply as under existing law. Thus, the credit allowed to a beneficiary by section 668(b) for U.S. income taxes paid by the trust, and the credit against tax for taxes imposed by foreign countries will continue to be available.

(e) *Limitation on tax.*—Section 7(e) of the bill adds a new section 669 to subpart D of part 1 of subchapter J of chapter 1 (relating to treatment of excess distributions by trusts).

SECTION 669. SPECIAL RULES APPLICABLE TO CERTAIN FOREIGN TRUSTS

Section 669 provides that a beneficiary who is a U.S. person and who satisfies certain additional requirements may elect between two methods of computing the limitation on tax attributable to an accumulation distribution received from a foreign trust created by a U.S. person. These two methods are in addition to the method available to the beneficiary of computing his tax in the ordinary way by including in income the entire amount of an accumulation distribution when it is paid, credited, or required to be distributed. The additional requirements referred to which must be satisfied by the beneficiary are those provided in section 669(b), relating to the furnishing of certain information by the beneficiary with respect to the operation and accounts of the trust. Information may be required to be furnished for each taxable year of the trust on the last day of which an amount is deemed distributed by the trust under section 666(a). The nature and extent of the information required is to be determined by regulations prescribed by the Secretary of the Treasury or his delegate.

First method of limiting tax

As noted above, section 669(a) provides for an election by the beneficiary as between two methods of computing the limitation on tax attributable to the receipt of an accumulation distribution. The first method is the one provided by existing law, and which is now contained in the next to the last sentence of section 668(a). However, section 669(a)(2)(B) provides that this method may not be elected if the 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). Thus, if a portion of an amount received as an accumulation distribution was accumulated by the trust during years when the beneficiary was unborn, the beneficiary is not permitted to elect the limitation on tax provided by section 669(a)(1)(A).

Second method of limiting tax

The second method of limiting tax is provided by section 669(a)(1)(B). Under this method the beneficiary's gross income for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed to him (determined without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to section 669(a)(1)(B)) and for each of his 2 taxable years immediately preceding such year is recomputed solely for purposes of determining the limitation on the beneficiary's tax for the current year. The income for each of such 3 years is recomputed by adding thereto an amount determined by dividing the amount required to be included in income under section 668(a) 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. There is then computed the increase in tax for each of such 3 years attributable to the increased amount of gross income. The aggregate of the increases in tax for such 3 years is divided by 3 to arrive at an average increase in tax for such 3 years. This average increase in tax, multiplied by the number of preceding taxable years of the trust from the income of which the distribution is made, is the limitation on the beneficiary's tax liability (before the application of any credit for taxes paid by the trust allowed by sec. 668(b)) with respect to the accumulation distribution.

The computation made under the alternate election provided by section 669(a)(1)(B) is modified in two cases. 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 section 669(a)(1)(B) is limited to the number of years to which section 666(a) applies, commencing with the most recent taxable year of the beneficiary. Also, no recomputation of gross income is to be made for a beneficiary for a taxable year for which he was not alive on the last day thereof; and if the beneficiary has no preceding taxable year, the recomputation of gross income is 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 section 669(a)(1)(B).

The application of the preceding paragraph may be illustrated by the following examples: Assume that a foreign trust created by a U.S. person accumulates $3,000 of income for one year and $7,000 for a second year and then distributes the accumulated income on January 1, 1965, to a beneficiary who is a U.S. person. The limitation on tax computed under section 669(a)(1)(B) would be determined by recomputing the beneficiary's gross income for 1964 and 1965 by adding $5,000 to each year. If the same distribution were made to an infant who was born in 1965, the limitation on tax would be computed by adding $5,000 to his gross income for such year. The resulting increase in tax would be multiplied by 2 to arrive at the limitation on the increase in his tax for 1965 attributable to such distribution.

Effect of prior election

Section 669(a)(3) provides special rules which have application when a beneficiary who is a U.S. person receives a second or succeeding accumulation distribution from a foreign trust created by a U.S. person.

If a beneficiary has elected the limitation on tax provided by section 669(a)(1)(B) (the second method described herein) with respect to an accumulation distribution, and with respect to a subsequent accumulation distribution he desires to elect the limitation on tax provided by section 669(a)(1)(A) (the method provided by existing law), for purposes of computing the limitation on tax with respect to the subsequent accumulation distribution the income of any year with respect to which an amount is deemed distributed to a beneficiary under section 666(a) is to 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 section 669(a)(1)(B) was made. The result of this rule is to require that for the purposes of computing the limitation on tax under section 669(a)(1)(A) with respect to an accumulation distribution, all previous elections are considered to have been made under section 669(a)(1)(A).

A special rule is also provided by section 669(a)(3) regardless of the limitation on tax elected with respect to a prior accumulation distribution when, with respect to a subsequent accumulation distribution, the limitation on tax provided by section 669(a)(1)(B) is elected by the beneficiary. When this occurs 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) is to be determined without regard to any such year with respect to which an amount was previously deemed distributed to such beneficiary.

(f) *Requirement of information return.*—Section 7(f) of the bill amends subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) by adding a new section 6047.

SECTION 6047. RETURNS AS TO CREATION OF OR TRANSFERS TO CERTAIN FOREIGN TRUSTS

Section 6047 provides for the filing of an information return on or before the 90th day after the creation of any foreign trust by a U.S. person or after the transfer of any money or property to a foreign trust by a U.S. person. The return is to be in such form and is to set forth, in respect of the foreign trust, such information as the Secretary of the Treasury or his delegate prescribes by regulation as necessary for carrying out the provisions of the income tax laws. The return is required to be filed by the grantor in the case of an inter vivos trust, the fiduciary of an estate in the case of a testamentary trust, or by the transferor to a foreign trust, as the case may be.

(g) *Penalty for failure to file return.*—Section 7(g) of the bill amends subchapter B of chapter 68 (relating to assessable penalties) by adding a new section 6677.

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

Section 6677(a) provides that, in addition to any criminal penalty provided by law (such as the penalty provided by sec. 7203 for willful failure to file a return), 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, is to 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.

Section 6677(b) provides that the assessment or collection of any penalty imposed by section 6677(a) is not to be subject to the deficiency procedures provided by subchapter B of chapter 63 of the code.

(h) *Definitions.*—Section 7(h) of the bill amends section 7701(a) (relating to definitions) by adding paragraphs (30) and (31). Paragraph (30) defines the term "U.S. person" to mean an individual who is a citizen or resident of the United States; a domestic partnership; a domestic corporation; and any estate or trust (other than a foreign estate or foreign trust, within the meaning of sec. 7701(a)(31)). Paragraph (31) defines the terms "foreign estate" and "foreign trust" to 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 of the code (relating to income taxes).

(i) *Technical amendments.*—Section 7(i) of the bill amends the tables of sections where necessary to reflect the addition of the new sections added by the bill.

(j) *Effective date.*—The amendments made by section 7 of the bill (other than by subsecs. (f), (g), and (h)) are to apply with respect to distributions made after the date of the enactment of the bill. The amendments made by subsections (f), (g), and (h) will take effect on such date of enactment.

SECTION 8. MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE OR FLOOD INSURANCE COMPANIES), ETC.

(a) *Imposition of tax.*—Subsection (a) of section 8 of the bill, which corresponds to subsection (a) of section 10 of the bill as passed by the House, amends the heading and table of sections for part II of subchapter L of chapter 1 of the 1954 Code to conform them to the substantive changes made by the bill. In addition, subsection (a) in effect strikes out existing section 821 of the code and substitutes a new section 821, relating to the tax on mutual insurance companies to which part II applies.

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

(a) *Imposition of tax.*—Subsection (a) of the new section 821 provides the general rule for taxing mutual insurance companies (including interinsurers and reciprocal underwriters). The tax will not apply to a mutual life insurance company, or to a mutual marine or mutual fire or flood insurance company subject to the tax imposed by section 831 of the 1954 Code. In addition, the tax will not apply if the alternative tax imposed by the new section 821(c) (relating to alternative tax for certain small companies) applies. Also, under subsection (d) of section 8 of the bill as amended by your committee, mutual insurance companies (other than life or marine) whose gross receipts (not including capital gains) for the taxable year do not exceed $150,000 will be exempt from tax under section 501(c)(15) of the 1954 Code.

The tax imposed by the new section 821(a) applies to each taxable year beginning after December 31, 1962. The tax is to consist of—

(1) a normal tax—

(A) in the case of taxable years beginning before July 1, 1963, of 30 percent of the mutual insurance company taxable income, or 60 percent of the amount by which such taxable income exceeds $6,000, whichever is the lesser; and

(B) in the case of taxable years beginning after June 30, 1963, 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) 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.

Under existing law a mutual insurance company which is subject to the tax on investment income only is exempt from tax if its mutual insurance company taxable income does not exceed $3,000. Similarly, existing law provides special notch relief if such a company has mutual insurance company taxable income between $3,000 and $6,000. Under the bill, companies having mutual insurance company taxable income (as defined in the new sec. 821(b)) which does not exceed $6,000 will be exempt from tax, and the special notch provision will apply if the company has mutual insurance company taxable income between $6,000 and $12,000.

(b) *Mutual insurance company taxable income defined.*—Subsection (b) of the new section 821 defines the term "mutual insurance company taxable income" for purposes of part II of subchapter L. Under this definition, mutual insurance company taxable income means the amount by which—

(1) the sum of—

(A) the taxable investment income (as defined in sec. 822(a)(1)),

(B) the statutory underwriting income (as defined in sec. 823(a)(1)), and

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

(2) the sum of—

(A) the investment loss (as defined in sec. 822(a)(2)), if any,

(B) the statutory underwriting loss (as defined in sec. 823(a)(2)), if any, and

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

If for any taxable year the amount determined under paragraph (2) of the new section 821(b) exceeds the amount determined under paragraph (1) of the new section 821(b), the mutual insurance company taxable income shall be zero.

(c) *Alternative tax for certain small companies.*—Paragraph (1) of the new section 821(c) provides an alternative tax which is in lieu of the tax imposed by section 821(a) for taxable years beginning after December 31, 1962. Except as provided in section 821(c)(3)(B), this tax applies in the case of every mutual insurance company described in section 821(c)(3)(A) and consists of—

(1) a normal tax—

(A) in the case of taxable years beginning before July 1, 1963, of 30 percent of the taxable investment income, or 60 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser; and

(B) in the case of taxable years beginning after June 30, 1963, 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

(2) a surtax of 22 percent of the taxable investment income (computed without regard to the deduction provided in sec. 242 for partially tax-exempt interest) in excess of $25,000.

Thus, paragraph (1) of the new section 821(c) provides, in effect, that certain small mutual insurance companies shall be taxed at regular corporate rates on taxable investment income only. Under the bill, such companies will continue to be taxed the same as under present law, except that the alternative 1-percent tax will not apply. Accordingly, if such a company has taxable investment income of less than $3,000, it is not subject to tax, and if the taxable investment income is between $3,000 and $6,000, it is entitled to special notch relief. Unless such a company makes an election to be taxed under section 821(a), its underwriting gains or losses will not be taken into account for purposes of determining its tax liability.

Paragraph (2) of the new section 821(c), like section 821(c) of existing law, provides a special tax reduction for companies subject to tax under section 821. Your committee's amendments, however, provide for larger dollar amounts. Thus, if the gross amount received during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) is over $150,000 but less than $250,000, the tax otherwise computed under paragraph (1) of section 821(c) is reduced to an amount which bears the same proportion to such tax as the excess over $150,000 bears to $100,000. Under the bill as passed by the House, if the gross amount received during the taxable year from items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) was over $75,000 but less than $125,000, the tax otherwise computed under paragraph (1) of section 821(c) was reduced to an amount which bore the same proportion to such tax as the excess over $75,000 bore to $50,000. However, this special relief provision is to apply only to companies which are subject to the tax imposed by the new section 821(c) and is not to apply in the case of companies which are subject to the tax imposed by the new section 821(a).

Subparagraph (A) of the new section 821(c)(3) provides that, except as provided by section 821(c)(3)(B), every mutual insurance company (other than a life insurance company and other than a fire or flood or marine insurance company subject to the tax imposed by sec. 831) is to be subject to the tax imposed by section 821(c) if the gross amount received during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) exceeds $150,000 but does not exceed $600,000. The $150,000 and $600,000 are amounts increased by your committee's amendments from amounts of $75,000 and $300,000, respectively, in the bill as passed by the House.

Subparagraph (B) of the new section 821(c)(3) provides that a mutual insurance company described in section 821(c)(3)(A) shall not be subject to the alternative tax imposed by section 821(c)(1) for the taxable year if there is in effect for the taxable year an election made by such company under section 821(d) to be taxable under section 821(a), of if there is any amount in the protection against loss account of such company at the beginning of the taxable year. Where the alternative tax treatment for certain small companies does not apply by reason of there being an amount in the protection against loss account at the beginning of the taxable year, the bill provides that an election may be made to subtract such amount from the protection against loss account as of the close of the preceding taxable year. (See sec. 824(d)(5).)

(d) *Election to include statutory underwriting income or loss.*—Paragraph (1) of the new section 821(d) provides that any mutual insurance company which is subject to the tax imposed by section 821(c) may elect to be subject to the tax imposed by section 821(a). Paragraph (2) provides that if the company makes such an election it shall be subject to the tax imposed by section 821(a) for the first taxable year for which the election is made and for all taxable years thereafter unless the Secretary of the Treasury or his delegate consents to a revocation of such election. Under the bill, it is not intended to permit such companies an annual election to be taxed either under subsection (a) or (c) of the new section 821. However, there may be some situations where because of a substantial change in the character of the taxpayer's operations there would be an undue burden or material hardship if such taxpayer were not permitted to revoke its prior election. Under such circumstances, the bill provides that the election may be revoked with the consent of the Secretary of the Treasury or his delegate. If, however, for any taxable year for which the election would otherwise apply, the gross amount received by the company during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) does not exceed $150,000, such election will terminate automatically. Thus, if for any taxable year after such a termination such a company has gross receipts from such sources of over $150,000 but not more than $600,000, it shall be subject to tax under section 821(c) unless it makes a new election to be taxed under section 821(a).

(e) *No U.S. insurance business.*—Subsection (e) of the new section 821 is identical with section 821(d) of existing law and provides that foreign mutual insurance companies (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by sec. 831) not carrying on an insurance business within the United States are not to be subject to tax under part II of subchapter L but shall be taxable as other foreign corporations. (See sec. 881 of the code.)

(f) *Special transitional underwriting loss.*—Paragraph (1) of this subsection, for which there is no corresponding provision in the bill as passed by the House, provides a special transitional rule for determining the mutual insurance company taxable income of every mutual insurance company which has been subject to the tax imposed by this section (as in effect before enactment of this subsection) for the 6 taxable years immediately preceding January 1, 1963, and which has incurred an underwriting loss for at least 5 of such 6 taxable years.

Paragraph (2) of the new section 821(f) provides, for purposes of this part, that the mutual insurance company taxable income for the taxable year of a company described in paragraph (1) shall be the mutual insurance company taxable income for the taxable year (determined without regard to this subsection) reduced by the amount by which—

(A) the sum of the underwriting losses of such company for the 6 taxable years prior to January 1, 1963, reduced by the underwriting gain during such years, exceeds

(B) the total amount by which the mutual insurance company taxable income was reduced by reason of this subsection in prior taxable years.

Paragraph (3) of the new section 821(f) provides that for purposes of this subsection the term "underwriting loss" means the statutory underwriting loss, computed without any deduction under section 824(a), and that the term "underwriting gain" means statutory underwriting income, computed without any deduction under section 823(c) or any deduction under section 824(a).

Paragraph (4) of the new section 821(f) provides that this subsection shall only apply with respect to taxable years beginning after December 31, 1962, and before January 1, 1968, for which the taxpayer is subject to the tax imposed by section 821(a).

(g) *Cross-references.*—Subsection (g) of the new section 821, corresponding to subsection (f) of the bill as passed by the House, contains cross-references to section 501(c)(15) of the code (relating to exemption from tax of certain mutual insurance companies) and section 1201(a) (relating to alternative tax in case of capital gains).

SECTION 8. MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE OR FLOOD INSURANCE COMPANIES), ETC. (Continued)

(b) *Taxable investment income.*—Subsection (b) of section 8 of the bill, which corresponds to subsection (b) of section 10 of the bill as passed by the House, contains technical amendments to sections 822 and 823 of the code. These amendments, in effect, retain the existing substantive provisions of section 822 but change the designation of the excess of gross investment income (as defined in sec. 822(b)) over gross investment deductions (as provided in sec. 822(c)) from "mutual insurance company taxable income" to "taxable investment income."

Subsection (b)(1) of section 8 of the bill changes the heading of section 822 to refer to taxable investment income and amends section 822(a) to define the terms "taxable investment income" and "investment loss" for purposes of part II of subchapter L. The investment loss is the excess of gross investment deductions over gross investment income.

Subsection (b)(2) of section 8 of the bill amends section 822(c) of the code (relating to deductions) and section 822(e) of the code (relating to foreign mutual insurance companies) by striking out the term "mutual insurance company taxable income" each place it appears and inserting in lieu thereof the term "taxable investment income". This amendment conforms to the amendment to section 822(a).

Subsection(b)(3) of section 8 of the bill amends section 822(c)(7) of the code (relating to special deductions) and provides that for purposes of paragraph (7) of section 822(c), in applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received), the reference in section 246(b) to "taxable income" is to be treated as a reference to "taxable investment income."

Subsection (b)(4) of section 8 of the bill redesignates section 823 of the code (relating to other definitions) as subsection (f) of the new section 822.

(c) *Statutory underwriting income or loss.*—Subsection (c) of section 8 of the bill, which corresponds to subsection (c) of section 10 of the bill as passed by the House, adds (after sec. 822(f), as redesignated by subsec. (b)(4) of sec. 8 of the bill) a new section 823, relating to determination of statutory underwriting income or loss, and a new section 824, relating to adjustments to provide protection against losses.

SECTION 823. DETERMINATION OF STATUTORY UNDERWRITING INCOME OR LOSS

(a) *In general.*—Paragraph (1) of the new section 823(a) defines the term "statutory underwriting income" for purposes of part II of subchapter L. Under this definition, statutory underwriting income is the amount by which—

(1) 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 (as determined under sec. 822(b)), exceeds

(2) the sum of—

(A) 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) (relating to deductions in computing taxable investment income), plus

(B) the deductions provided in subsection (c) of the new section 823 (relating to special deduction for small company having gross amount of less than $1,200,000) and in section 824(a) (relating to deduction to provide protection against losses).

Thus, generally, the income of a company subject to tax under section 821(a) will be derived from the income as computed if it were subject to tax under section 831. For example, under existing law, mutual fire and casualty insurance companies must annually accrue all market discount attributable to the taxable year on bonds or securities which they hold. (See sec. 822(d)(2).) For purposes of computing taxable investment income this rule will continue to apply. However, since in computing statutory underwriting income, taxable investment income is subtracted from income determined as if the company were subject to tax under section 831, and since market discount is not required to be annually accrued by companies subject to the tax imposed by section 831, the effect is to understate what would otherwise be the statutory underwriting income by an amount equal to the amount of such accrual. Accordingly, the net effect under the bill, is that mutual fire and casualty insurance companies subject to the tax imposed under section 821(a) will treat market discount in the same manner as such item is presently treated in the case of a company subject to tax under section 831. In the case of a company subject to tax under section 831, any income attributable to market discount is subject to capital gains treatment at such time as the bond is sold or redeemed.

Paragraph (2) of the new section 823(a) provides that, for purposes of part II of subchapter L, the term "statutory underwriting loss" means the amount by which the amount referred to in paragraph (1)(B) of the new section 823(a) exceeds the amount referred to in paragraph (1)(A) of the new section 823(a).

Paragraphs (1) and (2) of the new section 823(a) provide, in effect, that for purposes of determining statutory underwriting income or loss for the taxable year a mutual insurance company subject to the tax imposed by section 821(a) must first take into account the same gross income and deduction items (except as modified by sec. 823(b)) as a taxpayer subject to tax under section 831 would take into account for purposes of determining its taxable income under section 832. These items are then reduced to the extent that they include amounts which are included in determining taxable investment income under section 822(a). In addition, the taxpayer is allowed a deduction for the amount determined under section 824(a) (relating to deduction to provide protection against losses) and, in the case of a company having gross receipts of less than $1,200,000, an additional deduction equal to the amount determined under section 823(c)(1), after the application of the limitation provided in section 823(c)(2).

(b) *Modifications.*—Subsection (b) of the new section 823 provides certain modifications to the general rule for determining statutory underwriting income or loss contained in section 823(a). Paragraph (1) of section 823(b) provides that for purposes of applying section 823(a), the deduction for net operating losses provided by section 172 is not to be allowed. (However, a company is allowed an unused loss deduction under the provisions of sec. 825.) Paragraph (2) of the new section 823(b) provides a special rule which applies in the case of an interinsurer or reciprocal underwriter which is subject to the tax imposed by section 821(a). This rule provides that if such a company, before the 16th day of the 3d month following the close of the taxable year, credits the individual account of each of its subscribers with an amount, representing savings to subscribers for the taxable year, which it would be obligated to pay promptly to such subscriber if he terminated his contract at the close of the company's taxable year, then—

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

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

Any amount representing savings credited to his account for the taxable year is to be treated by the subscriber as a dividend paid or declared for purposes of his taxable income. Thus, the amount of any savings credited to a subscriber within the meaning of this section shall be taken into account by him in computing his income to the extent that the cost of the insurance with respect to which the savings are credited constitutes a business expense.

(c) *Special deduction for small company having gross amount of less than $1,200,000.*—Subsection (c) of the new section 823 is identical to the bill as passed by the House, except for the increase in the gross amount provided by your committee's bill and relates to the special deduction for certain small companies having gross receipts of less than $1,200,000. Paragraph (1) of the new section 823(c) provides that if the gross amount received during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and net premiums (including deposits and assessments) is less than $1,200,000, then, subject to the limitation provided in paragraph (2) of the new section 823(c) there shall be allowed an additional deduction for purposes of determining statutory underwriting income or loss (under subsec. (a) of the new sec. 823) for the taxable year. This additional deduction is $6,000; except that if the gross amount exceeds $600,000, the additional deduction is limited to an amount equal to 1 percent of the amount by which $1,200,000 exceeds such gross amount. The special deduction provided by paragraph (1) does not apply if the taxpayer is either subject to the tax imposed by section 821(c) (relating to alternative tax for certain small companies) or has gross amounts of $1,200,000 or more.

Paragraph (2) of the new section 823(c) provides that the amount of the deduction allowed under paragraph (1) of the new section 823(c) is not to exceed the statutory underwriting income (as defined in sec. 823(a)(1)) for the taxable year, computed without regard to the deduction under paragraph (1) or the deduction allowed under section 824(a) (relating to deduction for protection against losses).

Example: The application of section 823(c) may be illustrated by the following example:

Company M, a mutual insurance company subject to the tax imposed by section 821(a), has the following items for the taxable year 1963:

Gross amount for purposes of sec. 823(c)(1)	$800,000
Gross investment income (including capital gains)	150,000
Capital gains	100,000
Gross income under sec. 832	900,000
Deductions under sec. 822(c)	142,000
Deductions under sec. 832 (as modified by sec. 823(b))	866,000

Under the provisions of section 823(c), company M's special small company deduction for the taxable year 1963 would be $4,000, computed as follows:

(1) Gross amount for purposes of sec. 823(c)(1)		$800,000
(2) Amount by which $1,200,000 exceeds item (1) ($1,200,000 minus $800,000)		400,000
(3) 1 percent of item (2), not to exceed $6,000		4,000
(4) Gross income under sec. 832, reduced by gross investment income ($900,000 minus $150,000)	$750,000	
(5) Deductions under sec. 832 (as modified by sec. 823 (b)), reduced by deductions under sec. 822(c) ($866,000 minus $142,000)	724,000	
(6) Limitation on deduction under sec. 823(c)(1) (excess, if any, of item (4) over item (5))		26,000
(7) Deduction under sec. 823(c)(1) (item (3) or item (6), whichever is the lesser)		4,000

SECTION 824. ADJUSTMENTS TO PROVIDE PROTECTION AGAINST LOSSES

(a) *Allowance of deduction.*—Paragraph (1) of the new section 824(a) provides that for purposes of determining the statutory underwriting income or loss (as defined in sec. 823(a)) for any taxable year there is to be allowed as a deduction to provide protection against losses the sum of—

(1) 1 percent of the losses incurred during the taxable year (as determined under sec. 832(b)(5)); plus

(2) 25 percent of the underwriting gain for the taxable year; plus

(3) if the concentrated windstorm, etc., premium percentage for the taxable year (as defined in par. (2) of the new sec. 824(a)) exceeds 40 percent, the amount determined by applying so much of the concentrated windstorm, etc., premium percentage as exceeds 40 percent to the underwriting gain for the taxable year.

This paragraph is the same as the corresponding provision under the bill as passed by the House, except that under your committee's amendments the excess of the premium percentage over 40 percent, instead of 50 percent, is used in determining that part of the protection against loss deduction provided by subparagraph (C).

For purposes of paragraph (1) of the new section 824(a), the term "underwriting gain" means the statutory underwriting income computed under section 823(a) without regard to the deduction provided by paragraph (1) of the new section 824(a).

Subparagraph (C) of the new section 824(a)(1) permits an additional deduction for protection against losses in the case of certain companies having concentrated windstorm, etc., risks. For example, assume that for the taxable year 1963, W, a mutual insurance company subject to the tax imposed by section 821(a), has an underwriting gain (for purposes of sec. 824(a)) of $100. Assume further that W's concentrated windstorm, etc., premium percentage (as determined under sec. 824(a)(2)) for the taxable year is 70 percent, and losses incurred during the taxable year are $1,000. Under the provisions of section 824(a), W's deduction for protection against losses for 1963 would be $65. Of this amount, $10 (1 percent of losses incurred, or 1 percent of $1,000) is due to the application of section 824(a)(1)(A), $25 (25 percent of underwriting gain, or 25 percent of $100) is due to the application of section 824(a)(1)(B), and $30—the amount determined by multiplying the underwriting gain by so much of the concentrated windstorm, etc., premium percentage as exceeds 40 percent, or 30 percent (70 percent minus 40 percent) times $100—is due to the application of section 824(a)(1)(C).

Paragraph (2) of the new section 824(a) defines the term "concentrated windstorm, etc., premium percentage." This definition is changed from that of the bill as passed by the House only by the addition in the bill as reported of a provision for losses arising within a 200-mile radius of any point selected by the taxpayer. Thus, for any taxable year the percentage is obtained by dividing—

(1) the amount of the premiums earned on insurance contracts during the taxable year (as defined in sec. 832(b)(4)), to the extent attributable to insurance against losses arising either in any one State or within 200 miles of any fixed point selected by the taxpayer from windstorm, hail, flood, earthquake, or similar hazards, by

(2) the total amount of the premiums earned on insurance contracts during the taxable year (as defined in sec. 832(b)(4)).

The taxpayer may annually select, within the period of limitation allowed, any geographical area permitted by this paragraph. For example, a company located in Springfield, Ill., may in one year use as the numerator of the fraction the amount of premiums attributable to special insurance risks located within the State of Illinois; in the second year the amount of premiums attributable to such insurance risks located within 200 miles of Peoria; and in the third year the amount of premiums attributable to such insurance risks located within 200 miles of Cedar Rapids, Iowa. For purposes of this paragraph, the term "similar hazards" includes tornadoes, cyclones, and similar natural phenomena but does not include insurance against fires, explosions, or riots. In the case of a company which issues contracts insuring against a combination of risks, some of which are included under this paragraph and some of which are not included under this paragraph, a reasonable allocation of the premiums earned for the taxable year with respect to such contracts will be made for purposes of determining such company's concentrated windstorm, etc., premium percentage for the taxable year.

(b) *Protection against loss account.*—Subsection (b) of the new section 824 requires every insurance company subject to the tax imposed by section 821(a) for any taxable year to establish and maintain a protection against loss account. This account is to be established for taxable years beginning after December 31, 1962, and the beginning or opening balance of such account is to be zero.

(c) *Additions to account.*—Subsection (c) of the new section 824 relates to the amount which is to be added to the protection against loss account for each taxable year for which the taxpayer is subject to the tax under section 821(a). Subsection (c) of the new section 824 provides that the amount to be added to the protection against loss account is to be an amount equal to the deduction for protection against losses provided by section 824(a)(1).

(d) *Subtractions.*—Paragraphs (1), (4), and (5) of the new section 824(d) sets forth the amounts which are to be subtracted from the protection against loss account. The amount which is required to be subtracted under section 824(d) is taken into account under section 821(b)(1)(C) for purposes of determining mutual insurance company taxable income. Except for the amendments described below, the subtractions required under your committee's bill are identical with those provided in the bill as passed by the House.

Paragraph (1) of the new section 824(d) provides that, after making the additions required by section 824(c) for the taxable year, there shall be subtracted from the protection against loss account—

(A) first, an amount equal to the excess (if any) of the protection against loss deduction allowed under section 824(a) for the taxable year over the underwriting gain (as defined in sec. 824(a)(1)) for the taxable year,

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

(i) the sum of the investment loss for such year and the statutory underwriting loss (reduced by the amount referred to in subpar. (A)) for such year, exceeds

(ii) the sum of the statutory underwriting income 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 taxable year,

(D) next, any amount remaining which was added to the account for the fifth preceding taxable year, minus one-half of underwriting gain remaining in the account for such taxable year which was added under 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 sec. 832(b)(4)) less dividends to policyholders (as defined in sec. 832(c)(11)), or

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

Under the bill as passed by the House, subparagraph (A) of the new section 824(d)(1) provided that the first subtraction from the protection against loss account was to have been made for so much of the statutory underwriting loss as was generated either by the deduction for dividends to policyholders (as defined in sec. 832(c)(11)) or by the deduction provided in section 824(a) for protection against losses. Thus, under the bill as passed by the House, any underwriting loss which was attributable to the payment of policy dividends could not be applied against taxable investment income unless the balance in the protection against loss account had first been reduced to zero.

Your committee has amended subparagraphs (A) and (B) to provide in effect that any portion of the statutory underwriting loss which is attributable to the deduction for dividends to policyholders may first be applied against taxable investment income. Under your committee's amendments, however, no portion of the statutory underwriting loss which is attributable to the deduction for protection against losses provided in section 824(a) may be applied against taxable investment income since it is applied against the balance in the protection against loss account.

Under subparagraph (B) of the new section 824(d)(1), the statutory underwriting loss is subtracted from the protection against loss account but only to the extent that such loss exceeds the taxable investment income and the amount determined under subparagraph (A) for the taxable year. The adjustment for the amount subtracted under subparagraph (A) is required by reason of your committee's amendment to subparagraph (A), and prevents the same item from being subtracted from the protection against loss account more than once. In addition, subparagraph (B) provides that where there is an investment loss for the taxable year such loss must first be applied against statutory underwriting income and then any remaining amount must be applied against any balance in the protection against loss account. Or, if there is both a statutory underwriting loss after the reduction referred to in subparagraph (A) and an investment loss, the sum of these losses must be so applied. Only then may any remaining amount give rise to an unused loss.

Subparagraph (D) of the new section 824(d)(1) provides for the subtraction of certain amounts added to the protection against loss account for any taxable year under section 824(c) if such amounts remain in the account for 5 taxable years. Under subparagraph (D) of the new section 824(d), the entire amount remaining in the account from the fifth preceding taxable year which was added by reason of section 824(a)(1)(A) (relating to deduction for 1 percent of losses incurred during the taxable year) or section 824(a)(1)(C) (relating to additional deduction for certain companies having concentrated windstorm, etc., risks) is to be subtracted from the protection against loss account. There is also to be subtracted under subparagraph (D) of the new section 824(d)(1) an amount representing one-half of the amount remaining in the account with respect to such fifth preceding taxable year which was added by reason of section 824(a)(1)(B) (relating to deduction for 25 percent of underwriting gain for the taxable year). (For a special rule with respect to a reciprocal making the election provided in sec. 826(a), see sec. 826(d).)

Subparagraph (E) of the new section 824(d)(1) provides (taking into account the priority rule in sec. 824(d)(3)(B)), in effect, a ceiling on the amount which can be added to and remain in the protection against loss account for the taxable year for which the amount is added. Subparagraph (E) provides that if the total amount in the account (as determined under sec. 824(d)(2)) exceeds the greater of (1) 10 percent of premiums earned on insurance contracts during the taxable year (as defined in sec. 832(b)(4)) less dividends to policyholders (as defined in sec. 832(c)(11)), or (2) the total amount in the account at the close of the preceding taxable year, then the amount of such excess shall be subtracted from the protection against loss account.

Paragraph (2) of the new section 824(d) contains rules for determining the ceiling on the protection against loss account. It provides that for purposes of paragraph (1)(E) of the new section 824(d), the total amount in the account is to be determined—

(1) after the application of section 824(d) without regard to paragraph (1)(E) thereof, and

(2) without regard to amounts remaining in the account which were added, with respect to all taxable years, under section 824(a)(1)(C) (relating to additional deduction to provide protection against losses for certain companies having concentrated windstorm, etc., risks).

Under paragraph (2) of the new section 824(d), for purposes of determining the ceiling on the protection against loss account in the case of a company having concentrated windstorm, etc., risks, any amount added to the account by reason of the application of section 824(a)(1)(C) is not to be taken into account.

Paragraph (3) of the new section 824(d) provides rules relating to the priority in which the subtractions from the protection against loss account are to be made. Under paragraph (3)(A) of the new section 824(d) the amounts required to be subtracted from the protection against loss account under section 824(d)(1) (A), (B), and (C), are to be made—

(1) first (on a first-in, first-out basis) from amounts in the account with respect to the 5 preceding taxable years and the taxable year, and

(2) then from amounts in the account with respect to earlier years.

Under paragraph (3)(B) of the new section 824(d), the amounts required to be subtracted from the protection against loss account under section 824(d)(1)(E) are to be subtracted only from amounts in the account with respect to the taxable year.

Under paragraph (3)(C) of the new section 824(d), if the amount to be subtracted from the total amounts in the account with respect to any taxable year is less than such total, the amount required to be subtracted from the protection against loss account under section 824(d)(1) (A), (B), (C), and (E) is to be subtracted from each of the amounts referred to in section 824(a)(1) in the account with respect to such year in the proportion which each bears to the total amount in the account with respect to such year. For example, assume that for the taxable year 1966, N, a mutual insurance company subject to the tax imposed by section 821(a), is required to subtract $60 from its protection against loss account under section 824(d)(1) (other than under subpar. (E)). Assume that the total amount in the account for 1963 (the first preceding taxable year for which additions to the account were made) is $100. Assume further that of this $100 balance, $30 is due to the application of section 824(a)(1)(A), $50 is due to the application of section 824(a)(1)(B), and $20 is due to the application of section 824(a)(1)(C). Under paragraph (3)(C) of the new section 824(d), since the amount to be subtracted from the balance in the account with respect to 1963 is less than such balance, the amount to be subtracted from each of the amounts in the account with respect to such taxable year shall be in the proportion which each bears to such total. Accordingly, the amount in the account by reason of the application of section 824(a)(1)(A) shall be reduced by $18 (30/100×$60). The amount in the account with respect to the application of section 824(a)(1)(B) shall be reduced by $30

(50/100×$60). The amount in the account with respect to the application of section 824(a)(1)(C) shall be reduced by $12 (20/100×$60).

Paragraph (4) of the new section 824(d) provides that if the taxpayer is not subject to tax under part II of subchapter L for any taxable year, the entire amount in the protection against loss account at the close of the preceding taxable year is to be subtracted from the account in such preceding taxable year and included in mutual insurance company taxable income (as defined in sec. 821(b)) for such preceding taxable year.

Paragraph (5) of the new section 824(d) provides that for any taxable year for which the company is subject to the tax imposed by section 821(a), it may elect to subtract from its protection against loss account any amount which, except for the application of this election, would be in such account as of the close of such taxable year. The amount elected to be subtracted from the protection against loss account is to be included in mutual insurance company taxable income (as defined in sec. 821(b)) for the taxable year. The election must be made after the close of the taxable year for which it is to apply and not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year following such taxable year, and in such manner and form as the Secretary of the Treasury or his delegate may by regulations prescribe. The election is to apply only with respect to the taxable year for which it is made and once such an election has been made it may not subsequently be revoked.

Examples.—The application of new section 824(d) may be illustrated by the following examples:

Example 1.—For the taxable year 1969, X, a mutual insurance company subject to the tax imposed by section 821(a), has taxable investment income of 25 and a statutory underwriting loss of 22 (including a protection against loss deduction of 7 which is entirely attributable to the application of sec. 824(a)(1)(A)). The following table shows the protection against loss account of X before and after the application of section 824(d) for the taxable year 1969:

	1963	1964	1965	1966	1967	1968	1969
Protection against loss account: Balance remaining in account with respect to each taxable year (before application of sec. 824(d))	3	1	1	1	2	1	7
Balance remaining in account with respect to each taxable year (after application of sec. 824(d))	3	0	0	0	0	0	6

Under the provisions of section 824(d)(1)(A), for the taxable year 1969, X would subtract 7 from its protection against loss account (the amount by which the protection against loss deduction allowed under sec. 824(a) for the taxable year exceeds the underwriting gain for the taxable year, or 7 minus 0). Under the provisions of section 824(d)(3)(A), since the subtractions are to be made with respect to amounts in the account for the 5 preceding taxable years and the taxable year on a first-in, first-out basis, X would first apply the amount to be subtracted to the amount in the account with respect to 1964, 1965, 1966, 1967, and 1968, in that order. This would reduce the total amount in the account with respect to such taxable years by 6, and the balance in the account with respect to each of the taxable years 1964 through 1968 would be reduced to zero. The remaining amount required to be subtracted under section 824(d)(1)(A), 1 (7 minus 6), would then be subtracted from the amount added to the account for the taxable year, 7 (an amount equal to the protection against loss deduction for the taxable year 1969), leaving a balance of 6 (7 minus 1) in the account with respect to 1969. No proration of the subtraction from the amount in the account for 1969 is required under section 824(d)(3)(C) since the entire amount added to the account in 1969 was added by reason of section 824(a)(1)(A).

Example 2.—Assume the facts are the same as in example 1, except that X has taxable investment income of 7 (instead of 25) for the taxable year 1969. After the application of section 824(d) for the taxable year 1969, the results would be as follows:

Protection against loss account

	1963	1964	1965	1966	1967	1968	1969
Balance remaining in account with respect to each taxable year (after application of sec. 824(d))	1	0	0	0	0	0	0

Under the provisions of section 824(d)(1), for the taxable year 1969, X would subtract 15 from its protection against loss account. Of this amount, 7 would be attributable to the application of section 824(d)(1)(A) (i.e., the amount by which the protection against loss deduction allowed under sec. 824(a) for the taxable year exceeds the underwriting gain for the taxable year, or 7 minus 0), and 8 would be attributable to the application of section 824(d)(1)(B) (i.e., the amount by which the statutory underwriting loss for the taxable year, reduced by the amount determined under sec. 824(d)(1)(A), exceeds the taxable investment income for the taxable year, or the amount by which 15 (22 minus 7) exceeds 7). Under section 824(d)(3)(A)(i), this subtraction would be made (on a first-in, first-out basis) from amounts in the account with respect to 1964, 1965, 1966, 1967, 1968, and 1969, in that order. This would reduce the total amount in the account with respect to such taxable years by 13, and the balance in the account with respect to each of the taxable years 1964 through 1969 would be reduced to zero. Under the provisions of section 824(d)(3)(A)(ii), the remaining amount required to be subtracted under section 824(d)(A), 2 (15 minus 13), would then be subtracted from the amount in the account with respect to 1963 (i.e., the amount representing one-half of the amount added by reason of sec. 824(a)(1)(B) which was not required to be subtracted from the protection against loss account under sec. 824(d)(1)(D) in 1968). Thus, the amount in the account with respect to 1963 would be reduced to 1 (3 minus 2).

Example 3.—Assume that Y, a mutual insurance company subject to tax under section 821(a), has a protection against loss account which reflects the following items for the taxable years 1963 through 1968:

Additions to protection against loss account

	1963	1964	1965	1966	1967	1968
Additions:						
1 percent of losses incurred	15	20	60	60	60	60
25 percent of underwriting gain	60	20	40	50	45	45
Additional deduction for concentrated risks	0	0	5	5	0	0
Total	75	40	105	115	105	105

Y, in computing mutual insurance company taxable income for 1968, is required to subtract from the account with respect to 1963 the entire amount of the 1 percent of losses incurred added for 1963 (15) and one-half of the underwriting gain (30) added for such year. Upon taking into account these subtractions, the balance in the protection against loss account with respect to 1963 is 30 (the one-half remaining in the account after the application of par. (1)(D) of sec. 824(d)).

Assume further, that for the taxable year 1969, Y has taxable investment income of 50, underwriting gain of 80, resulting because of incurred losses of 4,000, expenses of 1,000, and premiums earned less dividends to policyholders of 5,080. Under section 824(a), the protection against loss deduction for 1969 is 60. After applying section 824(c), but before applying section 824(d) for 1969, the protection against loss account as of the close of 1969 (after subtracting in 1968 the 45 amount with respect to 1963) would be as follows:

Protection against loss account

	1963	1964	1965	1966	1967	1968	1969
Additions:							
1 percent of loss incurred	0	20	60	60	60	60	40
25 percent of underwriting gain	30	20	40	50	45	45	20
Additional deduction for concentrated risks	0	0	5	5	0	0	0
Total with respect to taxable year	30	40	105	115	105	105	60
Total (as of end of each year before 1969 subtractions)	30	70	175	290	395	500	560

After making the addition to the protection against loss account for 1969 and obtaining the results shown in the table above, Y is required to make the subtractions for 1969 from the account. These subtractions may be summarized as follows:

Subtractions under section 824(d) for 1969

Taxable year with respect to which amount is subtracted	1963	1964	1965	1966	1967	1968	1969
Par. (1)(A) subtraction	0	0	0	0	0	0	0
Par. (1)(B) subtraction	0	0	0	0	0	0	0
Par. (1)(C) subtraction	0	0	0	0	0	0	0
Par. (1)(D) subtraction	0	[1] 30	0	0	0	0	0
Par. (1)(E) subtraction	0	0	0	0	0	0	12
Pars. (4) and (5) subtraction	0	0	0	0	0	0	0

[1] 20 represents the amount added for 1964 with reference to incurred losses; 10 represents one-half of the amount added for 1964 with reference to underwriting gain.

After determining the subtractions with respect to years before 1969, the next step is to determine whether any subtraction is required for the taxable year 1969 under section 824(d)(1)(E). Since the total balance in the account after the application of section 824(d) (other than par. (1)(E) thereof), 520 (560 minus 30, and excluding 10 added to the account by reason of the additional deduction for protection against losses for concentrated windstorm, etc., companies provided by sec. 824(a)(1)(C)), exceeds 10 percent of premiums earned on insurance contracts during the taxable year less dividends to policyholders, 508 (10 percent of 5,080), Y would be subject to the ceiling on the protection against loss account for the taxable year 1969 and would be required to subtract 12 (the excess of 520 over 508) from the account under section 824(d)(1)(E). Under the provisions of section 824(d)(3)(B) this subtraction would be made only from amounts in the account with respect to the taxable year 1969. Under the provisions of section 824(d)(3)(C), however, since the amount to be subtracted, 12, is less than the total amount added to the account for the taxable year, 60 (40 plus 20), the subtractions under section 824 (d)(1)(E) would be applied ratably against each of the amounts added to the account for the taxable year. Thus, the amount remaining in the account with respect to section 824(a)(1)(A) for the taxable year 1969, would be 32 (40 minus $40/60 \times 12$, or 40 minus 8), and the amount remaining in the account with respect to section 824(a)(1)(B) for the taxable year 1969, would be 16 (20 minus $20/60 \times 12$, or 20 minus 4).

Based on these facts, Y's mutual insurance company taxable income for 1969 would be 112 (the sum of taxable investment income of 50, plus statutory underwriting income of 20 (underwriting gain minus protection against loss deduction, or 80 minus 60), plus subtractions from the protection against loss account under sec. 824(d) of 42).

SECTION 825. UNUSED LOSS DEDUCTION

(a) *Amount of deduction.*—Subsection (a) of the new section 825 provides that, for purposes of part II of subchapter L, the unused loss deduction (used in the determination of mutual insurance company taxable income under sec. 821(b)) shall be an amount equal to the unused loss carryovers and carrybacks to the taxable year.

(b) *Unused loss defined.*—Subsection (b) of the new section 825 defines the term "unused loss," for purposes of part II of subchapter L, as the amount by which—

(1) the sum of the statutory underwriting loss (as defined in sec. 823(a)(2)) and the investment loss (as defined in sec. 822(a)(2)), exceeds—

(2) the sum of—

(A) the taxable investment income (as defined in sec. 822(a)(1)),

(B) the statutory underwriting income (as defined in sec. 823(a)(1)), and

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

If the sum of the items under (1) does not exceed the sum of items under (2), the unused loss is zero.

(c) *Loss year defined.*—Subsection (c) of the new section 825 defines as the loss year, for purposes of part II of subchapter L, any taxable year in which a company subject to the tax imposed by section 821(a) has an unused loss which is more than zero.

(d) *Years to which carried.*—Subsection (d) provides that the unused loss for any loss year is to be an unused loss carryback to each of the 3 taxable years preceding the loss year and an unused loss carryover to each of the 5 taxable years following the loss year. (For certain taxable years to or from which an unused loss may not be carried, see section 825(g).)

(e) *Amount of carrybacks and carryovers.*—Subsection (e) of the new section 825 provides that for any loss year, the entire amount of the unused loss, determined under the provisions of section 825(b), shall be carried to the earliest of taxable years to which such loss may be carried under section 825(d) (subject to the limitations of sec. 825(g)). The amount of the unused loss carried to each of the other taxable year (permitted under section 825(d)), following the earliest taxable year shall be the excess of such loss over the sum of the offsets for each taxable year preceding the taxable year to which the loss is carried.

(f) *Offset defined.*—Subsection (f) of the new section 825 defines the term "offset," for purposes of section 824(e) and provides that the taxable year to which an unused loss is carried is to be referred to as the "offset year." "Offset" is defined as the mutual insurance company taxable income for the offset year in the case of an unused loss carryback from the loss year to the offset year. In the case of an unused loss carryover from the loss year to the offset year, the offset is the sum of the amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) for the offset year and the mutual insurance company taxable income for the offset year. For purposes of computing the offset, the mutual insurance company taxable income for the offset year (as defined in sec. 821(b)) shall be determined without regard to any loss carryback or carryover to the offset year from the loss year, or any year thereafter.

Example: The application of section 825 may be illustrated by the following example:

For the taxable year 1967, F, a mutual insurance company subject to the tax imposed by section 821(a), has the following items:

Taxable investment income	1
Underwriting loss	59
Addition to protection against loss account	8
Statutory underwriting loss	67

As explained below, the subtractions from protection against loss account are as follows:

Amount subtracted from amounts in account with respect to taxable years 1963 through 1966	18
Amount subtracted from amounts in account with respect to taxable year 1967	8
Total subtractions from protection against loss account under sec. 824(d)	26

The application of section 825 in this case may be illustrated by the facts and results shown in the following table and explained below:

	Taxable year—					
	1963	1964	1965	1966	1967	1968
Protection against loss account:						
Addition to account during taxable year	6	2	3	7	8	7
Subtraction from account during taxable year	0	0	0	0	8	7
Protection against loss account (at end of year)	6	2	3	7	0	0
Protection against loss account (at end of taxable year 1968)	0	0	0	0	0	0
Unused loss	0	0	0	0	40	0
Unused loss carryback	0	40	35	25	0	0
Unused loss carryover	0	0	0	0	0	18
Unused loss deduction	0	40	35	25	0	18
Mutual insurance company taxable income (computed without regard to unused loss)	13	5	10	7	0	2
Mutual insurance company taxable income (computed with regard to unused loss)	13	0	0	0	0	0
Offset for year	0	5	10	7	0	9
Offset total	0	5	15	22	0	31

1967: Under the provisions of section 825(b), F's unused loss for 1967 is 40, the amount by which the sum of the statutory underwriting loss and the investment loss, 67 (67 plus 0), exceeds the sum of the taxable investment income, the statutory underwriting income, and the amounts required to be subtracted from the protection against loss account under section 824(d) for the taxable year, 27 (the sum of 1, 0, and 26, respectively).

1967 carryback to 1964: Under the provisions of section 825(e), the entire unused loss for 1967 of 40 is carried back to 1964, the earliest year to which the loss may be carried under section 825(d). Since there are no other amounts carried to 1964, the unused loss deduction for 1964 is 40. Thus, after taking the unused loss deduction into account, the mutual insurance company taxable income for 1964 is zero, and the offset for 1964 is 5 (the mutual insurance company taxable income for 1964 determined without regard to the unused loss carryback from 1967 or any year thereafter).

1967 carryback to 1965: The portion of the unused loss for 1967 which is carried back to 1965 is 35 (40 minus 5, the offset for 1964). After taking the underwriting loss deduction into account, the mutual insurance company taxable income for 1965 is zero. The offset for 1965 is 10, the mutual insurance company taxable income for 1965 determined without regard to any unused loss carryback or carryover from 1967 or any year thereafter.

1967 carryback to 1966: The portion of the unused loss for 1967 which is carried back to 1966 is 25. This amount is the excess of the underwriting loss for 1967 of 40 over the sum of the offset for 1965 (5) and the offset for 1966 (10). Thus, as a result of the unused loss for 1967, the mutual insurance company taxable income for 1966 is reduced to zero. The offset for 1966 is 7.

1967 carryover to 1968: Under the provisions of section 825(d), the portion of the unused loss for 1967 which is carried forward to 1968 is 18 (40 minus the sum of 10, 5, and 7, the offsets for 1964, 1965, and 1966, respectively). Under section 825(f)(2), this amount is first applied against any amounts in the protection against loss account at the end of 1968, and is then applied against the mutual insurance company taxable income for 1968. Thus, assuming that there are no other subtractions from its protection against loss account under section 824(d) for 1968, F's protection against loss account of 7 is reduced to zero by reason of the subtraction under section 824(d)(1)(C). The remaining portion of the unused loss for 1967 which is carried to 1968, 11 (18 minus 7, the amount of the unused loss carryover to 1968 which is subtracted from the protection against loss account under sec. 824(d)(1)(C)), is then applied against the mutual insurance company taxable income for 1968. Thus, after the application of the unused loss deduction for 1968, the mutual insurance company taxable income for 1968 is zero. The offset for 1968 is 9, the sum of the amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) for 1968 (7), plus the mutual insurance company taxable income for 1968, determined without regard to the unused loss carryover from 1967 or any unused loss carryback from 1967 or any year thereafter (2). The remaining 9 of the unused loss for 1967 (40 minus the sum of 10, 5, 7, and 9, the offsets for 1964, 1965, 1966, and 1968, respectively), is carried forward to 1969, and to the extent not used in that year or any year thereafter, may be carried forward to 1970, 1971, and 1972, in that order.

(g) *Limitations.*—Subsection (g) of the new section 825 provides that, for purposes of part II of subchapter L, an unused loss (as defined in sec. 825(b)) may 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 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).

Examples.—The application of section 825(g) may be illustrated by the following:

Example 1.—For the taxable year 1963, M, a mutual insurance company subject to tax imposed by section 821(a), has an unused loss (as defined in sec. 825(b)) of $65,000. The loss may not be carried back to any taxable year beginning before 1963. However, the loss may be carried forward to each of the 5 taxable years following 1963 provided that for each of such succeeding taxable years M is subject to the tax imposed by section 821(a).

Example 2.—Assume the facts are the same as in example 1, except that for the taxable year 1964, the gross amount received by M from the items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) exceeds $150,000 but does not exceed $600,000. If M does not make the election under section 821(d) (relating to election to be taxed under sec. 821(a) for 1964), the loss will not be allowed as an unused loss carryover since, by reason of section 825(g)(3), the unused loss may not be carried 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), and by reason of section 825(g)(1), the unused loss may not be carried to any taxable year beginning before 1963.

SECTION 826. ELECTION BY RECIPROCAL

(a) *In general.*—Subsection (a) of the new section 826 provides that, except as provided in section 826(c), any insurance company which is an interinsurer or reciprocal underwriter (referred to in sec. 826 as a "reciprocal") subject to the tax imposed by section 821(a), may elect to be subject to the limitation provided in subsection (b) of the new section 826. Such election shall be made, under regulations prescribed by the Secretary of the Treasury or his delegate, not later than the time prescribed by law (including extensions thereof) for filing the return for the year for which such election is first to apply. The election is to apply for the taxable year for which made and for all succeeding taxable years and may not be revoked without the consent of the Secretary of the Treasury or his delegate. The effect of such election is to increase the income of the reciprocal by the income of its attorney-in-fact attributable to the reciprocal for purposes of computing the taxes imposed by section 821(a) and to allow such reciprocal a credit for the taxes paid by the attorney-in-fact with respect to the income attributed to the reciprocal.

(b) *Limitation.*—Subsection (b) of the new section 826 provides that a reciprocal making the election provided under section 826(a) shall limit the deduction for amounts paid or incurred in the taxable year to the attorney-in-fact to such amounts as are deductible by the attorney-in-fact in respect of the income received by the attorney-in-fact from the reciprocal. In no case may such deduction of the reciprocal be increased by the deductions of the attorney-in-fact allocable to the income received from the reciprocal.

(c) *Exception.*—Section 826(c) provides that no election under section 826(a) may be made by a reciprocal unless its attorney-in-fact—

(1) is a corporation subject to the taxes imposed by section 11 (b) and (c) of subtitle A;

(2) consents to make available such information as may be required during the period in which an election made under subsection (a) is in effect;

(3) reports income received from the reciprocal and deductions allocable thereto under the same method of accounting used by the reciprocal in reporting deductions for amounts paid or incurred to the attorney-in-fact; and

(4) files its return on a calendar-year basis.

(d) *Special rule.*—Under the bill as passed by the House, the limitation under section 826(b) would not have been taken into account by any reciprocal electing under section 826(a) either for purposes of computing the protection against loss deduction provided in section 824(a) or for purposes of computing the addition to the protection against loss account provided in section 824(c). Thus, in effect, a reciprocal making the election would not have included any of the income of the attorney-in-fact in computing its protection against loss deduction. Your committee has amended this section to provide that the protection against loss deduction, and the amount added to the protection against loss account, for the taxable year, may be increased to reflect any amounts attributable to the consolidation permitted under this subsection. However, your committee has provided a special rule that in applying section 824(d)(1)(D) any amount which was added to the protection against loss account by reason of such an election shall be treated as having been added by reason of section 824(a)(1)(A). The effect of this special rule is that no portion of the amount added to the protection against loss account by reason of the election under section 826(a) (i.e., the amount by which 25 percent of consolidated underwriting income exceeds 25 percent of underwriting income determined prior to consolidation), may be deferred for more than 5 years.

(e) *Credit.*—Subsection (e) of the new section 826 provides that any reciprocal electing to be subject to the limitation provided in subsection (b) shall be credited with the tax paid by its attorney-in-fact with respect to the income of the reciprocal in such taxable year.

(f) *Surtax exemption denied.*—Subsection (f) of the new section 826 provides that any tax imposed upon the increase in the income of the reciprocal attributable to the limitation under subsection (b) shall be computed without regard to the $25,000 surtax exemption provided in section 821(a)(2).

(g) *Adjustment for refund.*—Subsection (g) of the new section 826 provides that 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 or refund as a result of the application of subsection (e) of the new section 826, the taxes of the reciprocal for the year in which such credit or refund is allowed shall be properly adjusted under regulations prescribed by the Secretary of the Treasury or his delegate. This adjustment prevents the reciprocal and the attorney-in-fact from obtaining a credit or refund with respect to the same tax.

For example, assume that a reciprocal has elected in 1963 to be subject to the limitation provided in section 826(b) and such election is still in effect in taxable year 1966. Assume further that in taxable year 1969 its attorney-in-fact receives a refund or credit with respect to taxable year 1966. In such case, the taxes of the reciprocal in taxable year 1969 shall be properly adjusted under regulations prescribed by the Secretary of the Treasury or his delegate.

(h) *Taxes of attorney-in-fact unaffected.*—Subsection (h) of the new section 826 provides that nothing in section 826 shall either increase or decrease the taxes imposed by chapter 1 on the income of the attorney-in-fact.

Example.—The application of section 826 may be illustrated by the following example:

For the taxable year 1963, R, a reciprocal underwriter subject to the taxes imposed by section 821(a), has the following items (determined before applying any election under sec. 826):

Gross income under sec. 832		$578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823(b)):		
Deduction for amounts paid by R to attorney-in-fact A	$100	
All other deductions	500	
Total deductions under sec. 832	600	
Deductions under sec. 822(c)		40
Incurred losses		400
Protection against loss deduction		4
Underwriting gain		0
Mutual insurance company taxable income		0
Unused loss		22
Credit or refund for taxes paid		0

Assume that the deductions of attorney-in-fact A allocable to the income received by A from R are 60 and the tax paid by A allocable to the income received from R is 16. If R elects to be subject to the limitation provided in section 826(b), the results for 1963 would be as follows:

Gross income under sec. 832		578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823(b)):		
Deduction for amounts paid by R to attorney-in-fact A	60	
All other deductions	500	
Total deductions under sec. 832	560	
Deductions under sec. 822(c)		40
Incurred losses		400
Protection against loss deduction		6
Underwriting gain		8
Mutual insurance company taxable income		12
Unused loss		0
Credit or refund for taxes paid		16

Under the provisions of section 826(b), R's deduction for amounts paid or incurred to the attorney-in-fact in the taxable year 1963 would be limited to the deductions of A allocable to the income received by A from R. Thus, R's deductions under section 832 (as modified by sec. 823(b)) for 1963 would be 60 (the deductions of A which are allocable to the income received by A from R). As a result of making the election under section 826(a) for the taxable year 1963, R's underwriting gain would be 8, and its statutory underwriting income would be 2 (the underwriting gain of 8 minus the protection against loss deduction of 6—of which 4 represents the amount determined under sec. 824(a)(1)(A) and 2 represents the amount determined under sec. 824(a)(1)(B)—or 8 minus 6). Accordingly, R's mutual insurance company taxable income for 1963 would be 12. This amount consists of the taxable investment income of 10 (gross investment income minus deductions under sec. 822(c), or 50 minus 40) plus the statutory underwriting income of 2. Since all of R's mutual insurance company taxable income of 12 is attributable to the limitation under section 826(b), the entire amount is subject to the surtax under section 821(a)(2) without regard to the $25,000 surtax exemption. The credit of 16, representing that part of the taxes paid by A which is allocable to the income received by A from R, may be applied by R against its taxes with respect to its mutual insurance company taxable income of 12 for 1963, and R would be entitled to a refund of any excess of the amount of such credit over its tax liability for 1963.

Under the provisions of section 826(d), no portion of the amount added to such account in 1963 by reason of the election under section 826(a), 2 (25 percent of the amount by which the consolidated underwriting gain exceeds 25 percent of the underwriting gain determined without regard to the election under sec. 826(a), or the amount by which 25 percent of 8 exceeds 25 percent of 0), may be permitted to continue to remain in the protection against loss accounts beyond the taxable year 1968.

(d) *Exemption from tax.*—The bill as reported by your committee adds an amendment to section 501(c)(15) (relating to exemption from tax of certain mutual insurance companies) by striking out "$75,000" and inserting in lieu thereof "$150,000". Thus, the $75,000 exemption for certain mutual insurance companies under existing law is increased to $150,000, in accordance with the changes made in section 821 by your committee.

SECTION 8. MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE OR FLOOD INSURANCE COMPANIES), ETC. (Continued)

(e) *Mutual fire insurance companies operating on basis of premium deposits.*—Subsection (e) of section 8 of the bill, which corresponds to subsection (d) of section 10 of the bill as passed by the House, amends section 831(a) of the 1954 Code to include mutual fire insurance companies operating on the basis of premium deposits among the companies which are subject to the tax imposed by part III of subchapter L of chapter 1 of the code. Your committee's amendment adds mutual flood insurance companies to this group.

(*1*) *Application of section 831(a).*—Subsection (e)(1) of section 8 of the bill amends section 831(a) of the code (which imposes a tax on certain mutual marine and mutual fire insurance companies and on stock insurance companies which are not life insurance companies) to provide that, for taxable years beginning after December 31, 1962, mutual fire or flood insurance companies operating on the basis of premium deposits are to be subject to tax under part III of subchapter L. Under existing law, mutual fire insurance companies operating on the basis of premium deposits (the so-called factory mutual insurance companies) are taxed in the same manner as any other mutual insurance company (other than a life or marine or fire insurance company issuing perpetual policies); thus, these companies are subject to the tax imposed by section 821. (See *Philadelphia Manufacturers Mutual Insurance Company* v. *Commissioner* (1959), 33 T.C. 490, aff'd (C.A. 3d 1960) 284 F. 2d 296.) Under the bill, every mutual fire or flood insurance company 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, will be subject to the tax imposed by section 831(a) 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. For purposes of this subsection, in the case of a mutual flood insurance company, the premium deposits will be considered to be the same if the payment of a premium increases the total insurance under the policy in an amount equal to the amount of such premium, and the omission of any annual premium does not result in the reduction or suspension of coverage under the policy.

(*2*) *Treatment of unabsorbed premium deposits.*—Subsection (e)(2) of section 8 of the bill amends section 832(b)(4) of the code (relating to definition of premiums earned) to provide that for purposes of determining the premiums earned on insurance contracts during the taxable year in the case of a mutual fire or flood insurance company operating on the basis of premium deposits, the term "unearned premiums" means (with respect to the policies described in sec. 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 company's taxable year if all of such policies were terminated at such time. This paragraph further provides that for purposes of determining the amount which such company would be obligated to return to its policyholders at the close of any taxable year, the company must use its own schedule of unabsorbed premium deposit returns then in effect.

(*3*) *Conforming amendments.*—Subparagraph (e)(3) of section 8 of the bill amends section 832(b)(1)(C) of the code (relating to definition of gross income) to conform to the amendment to section 831(a).

(*4*) *Adjustment of premium deposit.*—Subparagraph (e)(4) of section 8 of the bill amends section 832(c)(11) of the code (relating to deduction for dividends to policyholders) to provide that the term "dividends and similar distributions" includes amounts returned or credited to policyholders on cancellation or expiration of factory mutual policies described in the new section 831(a)(3)(B).

(*5*) *Additional item of income.*—Subparagraph (e)(5) of section 8 of the bill amends section 832(b)(1) of the code (relating to the definition of gross income) to provide that, in the case of a mutual fire or flood insurance company operating on the basis of premium deposits, gross income includes an amount which is equal to 2 percent of 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. The term "premiums earned on insurance contracts during the taxable year", for purposes of this section, means thea bsorbed premiums for the taxable year determined in accordance with the schedule of unabsorbed premium deposits in effect at the end of the taxable year.

(f) *Election of certain mutual companies to be taxed on total income.*—Subsection (f) of section 8 of the bill, which corresponds to subsection (e) of section 10 of the bill as passed by the House, amends section 831 of the code (relating to tax on insurance companies (other than life or mutual), mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies) by redesignating subsection (c) as subsection (d) and adding a new subsection (c). The new section 831(c) provides that 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 to be subject to the tax imposed by section 831, whether or not marine insurance is its predominant source of premium income. If such election is made, the electing company shall be subject to the tax imposed by section 831, for years beginning after December 31, 1961, rather than subject to the tax imposed by section 821. Such election shall not be revoked except with the consent of the Secretary of the Treasury or his delegate.

(g) *Technical amendments, etc.*—This subsection, which corresponds to subsection (f) of the bill as passed by the House, makes certain technical changes to provisions of the 1954 Code outside of parts II or III of subchapter L to conform those provisions to the changes in subchapter L made by section 8 of the bill.

(*1*) *Credit for foreign taxes.*—Subsection (g)(1) amends section 841 of the code (providing for the allowance to an insurance company of the foreign tax credit provided in sec. 901) so as to define the term "taxable income," as used in section 904, to mean the mutual insurance company taxable income (as defined in sec. 821(b)) in the case of the tax imposed by section 821(a), and the taxable investment income (as defined in sec. 822(a)(1)) in the case of the tax imposed by section 821(c).

(*2*) *Adjustments to basis for depreciation sustained.*—Subsection (g)(2) amends section 1016(a)(3) of the code (relating to adjustments to basis for depreciation, etc., sustained) to provide, in effect, that any exhaustion, wear and tear, obsolescence, amortization, and depreciation, to the extent sustained (and to the extent sec. 1016(a)(2) does not apply), on property held in respect of any period since February 28, 1913, by a person subject to tax under part II of subchapter L (or the corresponding provisions of prior income tax laws), must be taken into account in determining the adjusted basis of such property.

(*3*) *Alternative tax on capital gains.*—Subsection (g)(3) amends section 1201(a) of the code (relating to alternative tax on capital gains) to conform to the amendment to section 821.

(*4*) *Clerical amendments.*—Subsection (g)(4) makes clerical conforming changes.

(h) *Effective date.*—Subsection (h) of section 8 of the bill provides that the amendments made by section 8 of the bill (other than by subsec. (f)) shall apply only with respect to taxable years beginning after December 31, 1962. Section 831(c) of the code, as added by subsection (f) of section 8, is applicable for taxable years beginning after December 31, 1961.

SECTION 9. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

Section 9 of the bill, corresponding to section 11 of the bill as passed by the House, deals with the method to be used for determining the amount of foreign income tax deemed to have been paid by domestic corporations with respect to dividends received from foreign corporations for purposes of allowance of a foreign tax credit under section 902 of the code. Section 9 of the bill revises section 902 of the code, and requires (under a new sec. 78) the inclusion of certain taxes deemed paid in income as a dividend from corporations other than certain less developed country corporations (the bill as passed by the House applied such rule to dividends from all foreign corporations). The new section 902 omits the present subsection (d), which provides a special rule for allowance of a foreign tax credit with respect to royalty or compensation payments made by certain wholly owned foreign subsidiaries to domestic parents in lieu of dividends. Section 9 also changes the source of income rule of section 861(a)(2)(B) with respect to dividend income received from a foreign corporation which derived income from sources within the United States and for which a dividends received deduction was allowed under section 245.

(a) *Entire amount of foreign tax to be taken into account.*—Subsection (a) of the new section 9 revises section 902. Paragraph (1) of subsections (a) and (b) of section 902 as revised, and subparagraph (A) of subsection (c)(1), provide a new formula for determining the amount of foreign income tax deemed to have been paid by a domestic corporation with respect to dividends received from a foreign corporation other than a less developed country corporation. Paragraph (2) of subsections (a) and (b), and subparagraph (B) of subsection (c)(1), of section 902 as revised continue existing law for determining the amount of foreign income tax deemed to have been paid by a domestic corporation with respect to dividends from less developed country corporations. Subsections (b)(1) and (c)(1)(A) apply only if subsection (a)(1) applies, and subsections (b)(2) and (c)(1)(B) apply only if subsection (a)(2) applies. The first clause of section 902(c)(1) of existing law defines accumulated profits as gains, profits, or income reduced by the amount of taxes with respect thereto. Under subsection (c)(1)(A) of section 902 as revised, however, accumulated profits are defined as gains, profits, or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed by a foreign country or possession of the United States on or with respect to such profits or income. Taxes imposed by the United States will, however, continue to reduce such accumulated profits.

The redefinition of accumulated profits increases the amount of taxes to be taken into account in applying the proportions provided in section 902 (a)(1) and (b)(1) of the code. Under existing law, a credit is allowed to a domestic corporation for all or a part of the foreign taxes paid on or with respect to the accumulated profits of the foreign corporation making a distribution. However, by the existing definition, accumulated profits are total profits less taxes thereon. The Supreme Court, in *American Chicle Co.* v. *United States*, 316 U.S. 450 (1942), has held that the amount of tax paid on or with respect to a foreign corporation's accumulated profits is the same proportion of total taxes on profits as accumulated profits is of total profits. Thus, if a corporation had total profits of $100, foreign taxes of $40, and therefore accumulated profits of $60, the amount of taxes paid on or with respect to accumulated profits would be $24 ($40×$60/100). If the accumulated profits of $60 were paid as a dividend, no more than $24 could be allowed as a credit as deemed paid under section 902 of existing law.

As amended, the section 902(c)(1)(A) definition will permit the taking into account of a stated proportion of total taxes under section 902(a)(1) and 902(b)(1). For such purpose it is no longer necessary to apply the *American Chicle* rule. Since accumulated profits would be total profits without reduction for taxes paid thereon, the amount of taxes paid on or with respect to accumulated profits would, in the above example, be $40 rather than $24.

Subsections (a)(1) and (b)(1) of section 902 as revised provide for the use of the proportion which distributed dividends bear to the accumulated profits in excess of foreign taxes. The result is to continue under such subsections the use of the ratios under existing law, but because of section 902(c)(1)(A) the amount against which the ratios operate is increased.

The application of these changes in a section 902(a)(1) computation may be illustrated by the following example involving corporation P, a domestic corporation which owns 100 percent of the voting stock of corporation FC, a foreign corporation not a less developed country corporation. It is assumed that all transactions have taken place within, and are related to, the same taxable year.

Example 1

(i)	Gains, profits, and income of corporation FC	$100
(ii)	Foreign tax paid by corporation FC with respect to such gains, profits, and income	30
(iii)	Accumulated profits of corporation FC computed without reduction for foreign taxes (sec. 902(c))	100
(iv)	Accumulated profits of corporation FC reduced by foreign taxes (sec. 902(a))	70
(v)	Dividends paid by corporation FC to corporation P	35
(vi)	Corporation P is deemed to have paid the same proportion of the total tax paid by corporation FC as dividends, determined without regard to section 78, bear to accumulated profits in excess of taxes: $30× 35/70	15

Example 1 will apply to all dividends received by a domestic corporation after December 31, 1964, from a foreign corporation (not a less developed country corporation), regardless of the year in which the profits from which such dividends were paid were accumulated. Example 1 will also apply with respect to dividends received by a domestic corporation from such a foreign corporation in its taxable years beginning after December 31, 1962, so long as the dividends from the foreign corporation are attributable to accumulated profits of the foreign corporation for its taxable years beginning after December 31, 1962. However, for periods before January 1, 1965, the *American Chicle* rule and the present section 902(a) treatment will continue to apply where the dividends from such a foreign corporation are attributable to accumulated profits for taxable years beginning before January 1, 1963. Following the established rule, a foreign corporation is considered to be making a distribution first from its accumulated profits for its current taxable year and then from its accumulated profits of its immediately preceding year, etc.

The following example illustrates the above rules where a dividend is distributed out of both accumulated profits for taxable years beginning after December 31, 1962, and accumulated profits for taxable years beginning before January 1, 1963. The facts are the same as in example 1 except for the noted differences:

Example 2

(i)	Gains, profits, and income of corporation FC in 1963		$100
(ii)	Foreign tax paid by corporation FC with respect thereto		40
(iii)	1962 accumulated profits and foreign tax:		
	Accumulated profits (existing sec. 902(c))		60
	Foreign tax		40
(iv)	Dividends paid by corporation FC to corporation P in 1963 and the year to which such dividends are attributable:		
	1963	$60	
	1962	30	
			90
(v)	Corporation P is deemed to have paid a foreign tax with respect to the 1963 accumulated profits of corporation FC computed in the same manner as in example 1 ($40×60/60)		40
(vi)	Corporation P is deemed to have paid a foreign tax with respect to the 1962 accumulated profits of corporation FC in the same manner as existing rules ($40×60/100×30/60)		12
(vii)	Total foreign tax corporation P is deemed to have paid ((v)+(vi))		52

The new subsections (a)(1), (b)(1), and (c)(1)(A), when applied to dividends received after December 31, 1964, will not be affected by the fact that there may have been in an earlier year a partial distribution of accumulated profits to which the *Chicle* rule applied. For example, if a wholly owned foreign subsidiary (not a less developed country corporation) of a domestic corporation had total profits of $100, upon which foreign taxes of $40 had been paid, accumulated profits under existing law would be $60. Under the *Chicle* rule the taxes paid with respect to the accumulated profits would be $24 ($40×$60/100). Upon a distribution of one-half ($30) of such accumulated profits the domestic parent would be entitled under existing section 902(a) to a maximum credit of $12. However, if at any time after 1964, the subsidiary distributes another dividend, $30, with respect to the accumulated profits of such earlier year, and taxes deemed paid, determined in accordance with new section 902(a)(1), will be the same proportion of total taxes as the dividend bears to accumulated profits in excess of foreign taxes. Thus, the total tax of $40 would be multiplied by the fraction 30/60 and the parent would be entitled under section 902(a), as amended, to a credit of $20. No account is to be taken of the foreign tax of $8 which, because of the *Chicle* rule, was not taken into account in the earlier dividend year.

If a dividend from a foreign corporation (not a less developed country corporation) is distributed out of its accumulated profits for a taxable year beginning after 1962, and such accumulated profits are composed in whole or in part of dividends which were received from accumulated profits of a foreign subsidiary of the foreign corporation accumulated in taxable years beginning after 1962, both subsections (a)(1) and (b)(1) applies. After 1964 the new subsections (a)(1) and (b)(1) of section 902 will apply whether the distributions are from accumulated profits of the foreign corporation and its foreign subsidiary for their taxable years beginning after 1962 or before 1963. The computation involving these rules may be illustrated by the following example involving corporation P, a domestic corporation which owns 100 percent of the voting stock of foreign corporation FC (not a less developed country corporation) which in turn owns 100 percent of the voting stock of foreign subsidiary FS. It is assumed that all transactions have taken place and are related to the taxable year 1963.

Example 3

(A) Application of section 902(b)(1) to determine tax deemed to be paid by corporation FS:

(i) Gains, profits, and income of corporation FS	$100
(ii) Foreign tax paid by corporation FS with respect to such gains, profits, and income	20
(iii) Accumulated profits in excess of taxes of corporation FS: $100 less $20	80
(iv) Dividends paid by corporation FS to corporation FC	40
(v) Corporation FS foreign tax which is deemed paid by corporation FC: $20×40/80	10

(B) Application of amended section 902(a)(1) to determine tax deemed to be paid by corporation P:

(i) Gains, profits, and income of corporation FC:	
Business profits	$100
Dividends from corporation FS	40
	140
(ii) Foreign tax paid by corporation FC with respect to its gains, profits, and income	40
(iii) Accumulated profits in excess of taxes paid by corporation FC: $140 less $40	100
(iv) Dividend paid by corporation FC to corporation P	80
(v) Foreign tax paid ($40) and deemed paid ($10) by corporation FC	50
(vi) Foreign taxes paid and deemed paid by corporation FC which are deemed paid by corporation P: $50×80/100	40

Where a dividend from a foreign corporation (not a less developed country corporation) before 1965 is attributable to its accumulated profits for a taxable year beginning after 1962, but which profits are composed in part of a dividend received by such foreign corporation from the accumulated profits of its foreign subsidiary for a taxable year or years of the subsidiary beginning before 1963, for purposes of computing the foreign tax credit a pro rata amount of the dividend received from the foreign corporation will be deemed to consist of accumulated profits of its foreign subsidiary attributable to the period before 1963. Existing law will apply to that portion of the foreign tax paid or accrued or deemed paid by the foreign corporation with respect to such pro rata amount of the dividend considered attributable to the accumulated profits of its subsidiary for taxable years before 1963 and the amendment made by section 9 of the bill will apply to the balance of such tax.

The new subsections (a)(1), (b)(1), and (c)(1)(A) apply to the extent that a domestic corporation receives dividends from the accumulated profits of a foreign corporation for a taxable year for which it is not a less developed country corporation, and shall apply although such accumulated profits include dividends from accumulated profits of another foreign corporation for a taxable year for which such other foreign corporation is a less developed country corporation. Such provisions do not apply if the dividend is from accumulated profits of a corporation for a taxable year for which it is a less developed country corporation even though such accumulated profits includes dividends from accumulated profits of another foreign corporation for a taxable year for which such other corporation is not a less developed country corporation.

The new subsection (d) of section 902 as revised defines a less developed country corporation for the purpose of section 902 as a foreign corporation—

(1) which, for its taxable year, is a less developed country corporation under section 955(c) (1) or (2), or

(2) which owns at least 10 percent of all classes of stock entitled to vote of a less developed country corporation under section 955(c)(1), derives at least 80 percent of its gross income for its taxable year from sources within less developed countries under section 955(c)(1)(A), and at least 80 percent in value of its assets on each day of such year consists of property described in section 955(c)(1)(B).

A foreign corporation which is a less developed country corporation for its first taxable year beginning after December 31, 1962, is to be treated as such for each of its prior taxable years. Thus, if, after December 31, 1964, a domestic corporation receives a dividend from a foreign corporation from its accumulated profits for a taxable year beginning before December 31, 1962, the rules of existing law apply if such foreign corporation is a less developed country corporation for its first taxable year beginning after December 31, 1962, without regard to its earlier status.

(b) *Inclusion in gross income of amount equal to taxes deemed paid.*—Subsection (b) of section 9 of the bill amends part II of subchapter B of chapter 1 (relating to items specifically included in income) by adding at the end thereof a new section 78. Section 78 requires a domestic corporation to include in gross income as a dividend an amount equal to the taxes deemed, as a result of section 902 (a)(1), (b)(1), and (c)(1)(A) of the code, as added by subsection (a) of section 9 of the bill, or as a result of section 960(a)(1)(C) (relating to taxes paid by foreign corporation), as added by section 12 of the bill, to have been paid by the domestic corporation, if the domestic corporation chooses the benefits of the foreign tax credit. Section 78 does not apply where the taxes attributable to a particular distribution are computed under present law. Thus, in the preceding example 1 corporation P will include $15 in gross income as a dividend. In example 2 corporation P will include only $40 in gross income since $12 of foreign tax deemed to be paid by corporation P is computed under existing rules. In example 3 corporation P will include $40 in gross income.

The amount included in gross income by operation of section 78 is treated as a dividend in the same manner as a dividend actually received by the domestic corporation from a foreign corporation. For example, a section 78 dividend is included in gross income under section 61(a)(7); is personal holding company income for purposes of section 543(a)(1); and may be a portion of accumulated taxable income for purposes of section 535. However, a section 78 dividend is not a dividend for purposes of section 245 of the code (relating to deduction for dividends received from certain foreign corporations).

(c) *Determination of source of dividends received from certain foreign corporations.*—Subsection (c) of section 9 of the bill amends section 861(a)(2)(B) of the code 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 100/85ths of the amount of the deduction allowable under section 245 in respect of such dividends." This restores the rule contained in section 119(a)(2)(B) of the 1939 Code, as added by the Revenue Act of 1951. The effect of the change is to establish a closer correlation between the operation of sections 245 and 861(a)(2)(B) than existing law provides.

Under present section 861(a)(2)(B), the excess of the amount of a dividend taken into account in determining the dividends received deduction under section 245 over the amount allowed as a deduction, is determined to be income from sources without the United States for purposes of the foreign tax credit provisions. As a result, 15 percent of that portion of the dividend considered as derived from sources within the United States within the meaning of section 245 is treated as income from sources within the United States for purposes of that section, but, conversely, is treated as income from sources without the United States under section 861(a)(2)(B) for foreign tax credit purposes. Subsection (c) removes this inconsistency by treating as income from sources without the United States for foreign tax credit purposes only the amount of the dividend in excess of one hundred eighty-fifths of the dividends received deduction.

(d) *Technical amendments.*—Subsection (d) of section 9 of the bill conforms the table of sections for part II of subchapter B of chapter 1 of the code to the addition of the new section 78 and adds a cross-reference to section 901 of the code. In addition it makes technical changes in section 535(b)(1) and 545(b)(1) to prevent the amendments made by section 9 of the bill from changing "accumulated taxable income" for purposes of the accumulated earnings tax and "undistributed personal holding company income" for purposes of the personal holding company tax and to offset the effects of section 78 whereby these incomes are increased by reason of the taxes deemed to have been paid under section 902 (a)(1), (b)(1), and (c)(1)(A). These technical changes will allow as a deduction the taxes deemed to have been paid under section 902 (a)(1), (b)(1), and (c)(1)(A).

(e) *Effective date.*—Subsection (e) of section 9 of the bill provides that the amendments made by section 9 are to be applicable to dividends which are received by domestic corporate taxpayers in their taxable years beginning after December 31, 1962, but only to the extent that such distributions are made out of the accumulated profits of foreign corporations for their taxable years beginning after December 31, 1962. However, the amendments made by section 9 of the bill will be applicable to all dividends received by domestic corporate taxpayers from foreign corporations after December 31, 1964, regardless of the year to which the accumulated profits are attributable.

If, before 1965, the distribution from a foreign corporation for its taxable year beginning after December 31, 1962, is out of profits which are attributable to a distribution received by such foreign corporation from its foreign subsidiary, the effectiveness of the amendments depends on the taxable year to which the subsidiary's distribution is attributable. If the distribution is out of the subsidiary's accumulated profits for taxable years beginning after December 31, 1962, the amendments will be applicable. However, if the distribution is attributable to the subsidiary's accumulated profits for taxable years beginning before January 1, 1963, the present law will continue in effect.

The amendments are not applicable to a domestic corporation receiving a distribution from a foreign corporation prior to January 1, 1965, unless such distribution (1) is made out of profits of a foreign corporation accumulated in a taxable year beginning after December 31, 1962, and (2) is received by the domestic corporation in a taxable year beginning after December 31, 1962. Therefore, if for example, a foreign corporation is on a calendar-year basis and it makes a distribution on November 15, 1963, out of its accumulated profits for 1963 to a domestic corporation whose taxable year began on December 1, 1962, the present law would be applicable.

SECTION 10. SEPARATE LIMITATION ON FOREIGN TAX CREDIT WITH RESPECT TO CERTAIN INTEREST INCOME

Section 10 of the bill, for which there is no corresponding provision in the bill as passed by the House, amends section 904 (relating to limitations on the foreign tax credit) by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) a new subsection (f) relating to special rules in case of certain interest income.

Existing law

Under section 904(a) of existing law a taxpayer may elect between two alternative limitations on the amount of the foreign tax credit:

(1) The per country limitation limits the credit for tax paid or accrued to any one foreign country (or U.S. possession) to the proportion of U.S. tax before credit which taxable income from sources within such country (or possession) bears to the entire taxable income;

(2) The overall limitation limits the total credit for taxes paid or accrued to all foreign countries or U.S. possessions to the proportion of U.S. tax before credit which taxable income from all sources without the United States bears to the entire taxable income.

Separate limitation for interest income.—Paragraph (1) of new subsection (f) requires a taxpayer to apply subsection (a) of section 904 (and the related rules of subsecs. (c), (d), and (e)) with respect to interest described in paragraph (2) separately from all other income.

Paragraph (2) defines the interest income to which paragraph (1) applies as taxable income from interest other than interest—

(A) derived from transactions directly related to the active conduct of a trade or business in a foreign country or U.S. possession,

(B) derived in the conduct of a banking, financing, or similar business, or

(C) received from a corporation in which the taxpayer owns at least 10 percent of the voting stock.

Paragraph (3) provides that the overall limitation does not apply to interest described in paragraph (2) and that the Secretary of the Treasury or his delegate shall by regulations prescribe the manner of application of the foreign tax credit carrybacks and carryovers where the taxpayer elects the overall limitation as to other income.

Paragraph (4) provides transitional rules for foreign tax credit carrybacks and carryovers. Under subparagraph (A), carrybacks of taxes paid or accrued in taxable years beginning after the date of enactment of the bill carried to taxable years beginning on or before such date are determined without regard to new subsection (f). Where such taxes are carried back to taxable years beginning on or before such date of enactment and are partially deemed paid or accrued in such taxable years, the excess, if any, when carried forward is deemed paid or accrued in a taxable year beginning after the date of enactment, with respect to—

(i) interest (described in par. (2)) in the ratio that taxes paid or accrued with respect to such interest to a foreign country or possession in the year in which the tax was actually paid or accrued (in excess of the applicable limitation for such year) bears to the total tax paid or accrued to such country or possession in such year (in excess of the applicable limitation for such year); and

(ii) other income in the ratio that taxes paid or accrued with respect to such other income to a foreign country or possession in the year in which the tax was actually paid or accrued (in excess of the applicable limitation for such year) bears to the total taxes paid or accrued to such country or possession for such year (in excess of the applicable limitation for such year).

Under subparagraph (B) taxes, paid or accrued in a taxable year beginning on or before the date of enactment, are when carried forward deemed paid or accrued in a taxable year beginning after such date with respect to—

(i) interest (described in par. (2)) in the ratio that taxes paid or accrued to a foreign country or possession in the later year with respect to such interest bears to the total taxes paid or accrued in such year to such country or possession; and

(ii) other income in the ratio that taxes paid or accrued to a foreign country or possession in the later year with respect to such other income bears to the total taxes paid or accrued in such year to such country or possession.

If the taxpayer uses the overall limitation provided in section 902 (a)(2) with respect to income other than the interest income to which paragraph (2) applies, the computation under subparagraphs (A) and (B) of paragraph (4) will, under the provisions of paragraph (3), be computed, with respect to such other income, on the basis of the overall limitation.

Example 1.—Corporation M, to which the per country limitation applies, has for the taxable year 1963 \$50,000 of taxable income described in paragraph (2) from sources within country X, \$100,000 of other taxable income from sources within that country, and \$150,000 of taxable income (none of which is interest income) from sources within country Y. M has no other income (or losses) from sources without the United States in 1963 and has total taxable income from all sources (including countries X and Y) of \$2 million. It pays or accrues income tax for 1963 to country X of \$15,000 with respect to income described in paragraph (2), and \$60,000 with respect to other income, and it pays or accrues \$75,000 income tax to country Y. M's U.S. tax (before credit) is \$1,040,000. M's country X foreign tax credit limitation with respect to interest described in paragraph (2), is $\$1,040,000 \times \frac{\$50,000}{\$2,000,000}$, or \$26,000, so that the full amount of the \$15,000 of country X tax is allowed as a credit for 1963. M's country X limitation on credit for taxes with respect to other income is $\$1,040,000 \times \frac{\$100,000}{\$2,000,000}$, or \$52,000 so that \$52,000 of the \$60,000 of country X tax with respect to such other income is allowed as a credit for 1963. M's country Y limitation, $\$1,040,000 \times \frac{\$150,000}{\$2,000,000}$, or \$78,000, is unaffected by the new subsection (f) since M has no taxable income described in paragraph (2) from sources within country Y. M's total foreign tax credit is therefore \$142,000 (\$15,000 + \$52,000 + \$75,000).

Example 2.—Assume the same facts as in example 1 except that M has elected the overall limitation. The limitation on the credit for foreign tax paid or accrued to country X with respect to the income described in paragraph (2) is $\$1,040,000 \times \frac{\$50,000}{\$2,000,000}$, or \$26,000, the same as in example 1, and would not change even if M also had taxable income described in paragraph (2) from sources within some other foreign country, since the overall limitation is unavailable with respect to income described in paragraph (2). M's overall limitation with respect to foreign tax on all other income is \$1,040,000 $\times \frac{\$100,000 + \$150,000}{\$2,000,000}$, or \$130,000, so that of the \$135,000 (\$60,000 + \$75,000) foreign taxes paid or accrued with respect to income other than income described in paragraph (2), \$130,000 is allowed as a credit. M's total credit is therefore \$145,000 (\$130,000 + \$15,000).

Example 3.—Corporation O, which does not elect the overall limitation, paid or accrued to country X for the taxable year 1962

\$100 of foreign tax in excess of the section 904 limitation. Corporation O has no income from sources within any other country. For 1963, O pays or accrues to country X \$20 in tax on income described in paragraph (2) and \$80 in tax on other income. The section 904 limitation for 1963 is \$50 with respect to income described in paragraph (2) and \$80 with respect to other income. With respect to the \$100 carryover from 1962, corporation O is deemed to have paid or accrued in 1963 \$20, i.e., $\frac{\$20}{\$100}\times\$100$. The remaining \$80 of the carryover may be carried to 1964, and assuming the same amount of taxes are paid or accrued in 1964 as in 1963 and the same limitations are applicable, O is deemed to have paid or accrued in 1964 \$16, i.e., $\frac{\$20}{\$100}\times\$80$.

Example 4.—Assume the same facts as in example 3 except that the limitation under section 904 for 1962 exceeds the tax paid or accrued for that year by \$10, and the limitation for 1964 with respect to income other than that described in paragraph (2) is \$50. Under these facts, the excess of the \$80 tax paid or accrued for 1964 with respect to other income over the limitation of \$50, or \$30, is carried back first to 1962, and \$10 will be deemed paid or accrued for that year. The remaining \$20 is carried to 1963, but no amount will be deemed paid or accrued in 1963 since the tax being carried back was paid or accrued with respect to income other than that described in paragraph (2) and the limitation for 1963 with respect to such income does not exceed the tax actually paid or accrued for such year with respect to such income.

Example 5.—Assume the same facts as in example 4 except that the limitation for 1964 with respect to income described in paragraph (2) is \$10. The excess of the \$20 tax paid or accrued for 1964 with respect to income described in paragraph (2) over the limitation of \$10, or \$10, is aggregated with the excess tax of \$30 paid in 1964 with respect to other income, making a total of \$40. Of this aggregate amount, \$10 will be deemed paid or accrued in 1962 as in example 4. Of the remaining \$30, \$7.50 $\left(\frac{\$10}{\$40}\times\$30\right)$ will be deemed paid or accrued in 1963 with respect to interest income described in paragraph (2). No amount will be deemed paid or accrued in 1963 with respect to other income because the limitation for that year with respect to other income (\$80) does not exceed the tax actually paid or accrued for that year with respect to such other income (\$80).

Effective date.—The new subsection applies with respect to taxable years beginning after the date of enactment of the bill but only with respect to interest resulting from transactions consummated after April 2, 1962.

SECTION 11. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES

This section is the same as section 12 of the bill as passed by the House except for the addition of a presumption in certain circumstances with respect to bona fide residence and a temporary exemption for certain noncash remuneration.

(a) *Limitation on amount and type of income excluded.*—Subsection (a) of section 11 of the bill amends section 911 of the 1954 Code. This amendment retains the provisions of section 911 which require, under certain circumstances, the exclusion of earned income from gross income of an individual who has been a bona fide resident, or is physically present, in a foreign country. However, under the amendment there will be dollar limitations on the amounts which may be excluded under section 911 by any individual. The amendment also imposes a requirement as to time of receipt and, for some purposes, attributes amounts received to the taxable year in which the services to which the amounts are attributable were performed. The amendment also provides that no amount received as a pension or annuity is excludable under section 911. Your committee has added amendments which provide a presumption in certain circumstances with respect to bona fide residence and a temporary exemption for certain noncash remuneration.

SECTION 911. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES

(a) *General rule.*—Subsection (a) of section 911, as amended by section 11 of the bill, is the same as existing law in that it provides that in the case of an individual citizen of the United States—

(1) who has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, or

(2) 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 the uninterrupted period or during an 18-month period, whichever applies, may be excluded from gross income. However, the amended section 911(a) contains a new provision to the effect that the amount excluded under that provision will be computed by applying special rules contained in subsection (c). The new provision referring to the special rules in subsection (c) is in lieu of the unlimited exclusion provided by existing law with respect to bona fide foreign residence, and the $20,000 limitation with respect to physical presence in a foreign country provided by existing law. Subsection (a) also retains the provision of existing law that no deductions (other than the deductions allowed by sec. 151, relating to personal exemptions) will be allowed to the extent such deductions are properly allocable to or chargeable against amounts excluded from gross income under such subsection.

(b) *Definition of earned income.*—Subsection (b) of the amended section 911 continues, without change, the existing definition of "earned income."

(c) *Special rules.*—Subsection (c) of section 911, as amended by the bill, provides rules for purposes of computing the amount excludable from gross income of an individual under section 911(a).

Paragraph (1) of section 911(c) contains the limitations on the amount excludable under section 911(a). It provides, as a general rule, that the amount excluded for any taxable year is not to exceed an amount which is to be computed on a daily basis at an annual rate of $20,000. However, the annual rate is to be $35,000 in the case of an individual who qualifies as a bona fide resident of a foreign country or countries under section 911(a)(1), but only with respect to taxable years (or a portion of a taxable year) occurring immediately after such individual has been a bona fide foreign resident for any uninterrupted period of 3 consecutive years (36 consecutive months). The amount excludable accrues on a daily basis throughout the taxable year. The number of days to be used in making the computation on a daily basis is the number of days in the taxable year for which the exclusion is claimed.

The manner of computing the amount excludable under section 911(a) on a daily basis at the prescribed annual rates may be illustrated by the following example:

Example.—A, a U.S. citizen, who files his returns on a calendar year basis, is privately employed, and is a bona fide resident of France for the period April 1, 1963, through June 30, 1968. The amounts excludable from his gross income for the various calendar years under the provisions of section 911(a) which are computed by applying the special rules contained in section 911(c) are not to exceed the following amounts: For the year 1963, $15,068.49 (275/365×$20,000); for the year 1964, $20,000 (366/366×$20,000); for the year 1965, $20,000 (365/365×$20,000); for the year 1966, $31,301.37 (90/365×$20,000 plus 275/365×$35,000); for the year 1967, $35,000; and, for the year 1968, $17,404.37 (182/366×$35,000).

An individual who, on January 1, 1963, has been a bona fide foreign resident for an uninterrupted period in excess of 3 consecutive years is immediately entitled to the benefits of the annual rate of $35,000. An individual who returns and takes up residence in the United States is, upon resuming bona fide foreign residence, only entitled to the benefits of the annual rate of $20,000 until such individual completes another uninterrupted period of 3 consecutive years of bona fide foreign residence.

Paragraph (2) of section 911(c) provides that, for purposes of applying the limitation in paragraph (1), amounts received are to be considered received in the taxable year in which the services to which the amounts are attributable are performed. For example, amounts received during the taxable year 1965 attributable to services performed during the taxable year 1964 will, for purposes of applying the limitation in section 911(c)(1), be considered received in the taxable year 1964. Thus, if I (to whom the $20,000 limitation applies) receives $16,000 in 1964 and $7,000 in 1965, both amounts being attributable to his 1964 services, $3,000 of the $7,000 received in 1965 would be includible in his gross income for 1965.

Paragraph (3) of section 911(c) provides in effect that in applying the rules of paragraph (1), the amount excludable under section 911(a) is to be neither increased nor decreased solely by operation of community property law.

The application of the rule contained in section 911(c)(3) may be illustrated by the following examples:

Example 1.—H, a U.S. citizen, qualifies under section 911(a) and receives $40,000 during a taxable year for services performed abroad during such taxable year. He has been abroad for less than 3 consecutive years. W, the wife of H, earns no income of her own and continues to live in a community property State in the United States. The marital domicile also continues in such State. H and W file a joint return. The aggregate amount excludable from gross income under section 911 is $20,000. If H and W had filed separate returns, the aggregate amount excludable under section 911 would be $20,000.

Example 2.—The facts are the same as in example 1, except that W also resides abroad. Whether H and W file their returns separately or jointly, the aggregate amount excludable under section 911 is $20,000. If W also qualifies under section 911(a) and receives $10,000 during the taxable year for services she performed abroad during such taxable year, the aggregate amount excludable under section 911 is $30,000 (whether a joint return or separate returns are filed).

Similarly, in a noncommunity property jurisdiction, if H and W both qualify under section 911(a) and receive $40,000 and $10,000, respectively, for services performed abroad during the taxable year, the aggregate amount excludable under section 911 is $30,000.

Paragraph (4) of section 911(c) establishes a requirement as to time of receipt by providing that 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 section 911(a). For example, an amount received on or before the close of the taxable year 1965 which is attributable to services performed during the taxable year 1964 will satisfy the requirement as to receipt of section 911(c)(4). However, an amount received after the close of the taxable year 1965 which is attributable to services performed during the taxable year 1964 will not satisfy the requirement as to receipt of section 911(c)(4) and, therefore, will in no event be excludable under section 911(a).

Subparagraph (A) of section 911(c)(5) provides that no amount received as a pension or annuity may be excluded under section 911(a). The result is the same whether the recipient of such pension or annuity is a resident or a nonresident of the United States. Subparagraph (B) provides that no amount included in gross income by reason of section 402(b) (relating to taxability of beneficiary of nonexempt trust), section 403(c) (relating to taxability of beneficiary under a nonqualified annuity), or section 403(d) (relating to taxability of beneficiary under certain forfeitable contracts purchased by exempt organizations) may be excluded under section 911(a). Thus, amounts contributed by an employer to certain plans which do not qualify under section 401 and in which an individual has nonforfeitable rights, must be included in such individual's gross income currently. The amounts of such contributions are not excludable under section 911(a).

Your committee has added a new paragraph (6) to section 911(c) which provides that a statement by an individual who has earned income from sources within a foreign country that he is not a resident of such country, if he is held not subject as a resident of that country to the income tax of that country by its authorities with respect to such earnings, shall be conclusive evidence that he is not a bona fide resident of that country for purposes of section 911(a)(1).

Your committee has also added a new paragraph (7) to section 911(c) which provides that if an individual receives compensation from sources without the United States (except from the United

States or any agency thereof) in the form of a right to use property or facilities, the limitation under section 911(c)(1) applicable with respect to such individual, (A) for a taxable year ending in 1963, shall be increased by an amount equal to the amount of such compensation so received during such year; (B) for a taxable year ending in 1964, shall be increased by an amount equal to two-thirds of such compensation so received during such year; and (C) for a taxable year ending in 1965, shall be increased by an amount equal to one-third of such compensation so received during such year.

Example 1.—X, a U.S. citizen who files his returns for the calendar year, qualifies under section 911(a) and has been abroad for less than 3 consecutive years. During the taxable years ending December 31, 1963, 1964, 1965, and 1966, X receives compensation in the form of a right to use a residence, such use having a fair market value of $6,000 per year. Under the provisions of section 911(c)(7), the applicable limitation under section 911(c)(1) will be increased in the following amounts:

Taxable year ending:	*Amount*
Dec. 31, 1963	$6,000
Dec. 31, 1964	4,000
Dec. 31, 1965	2,000
Dec. 31, 1966	0

Example 2.—The facts are the same as in example 10 except that X returns and takes up residence in the United States on July 1, 1965. X will be entitled to increase the applicable limitation under section 911(c)(1) for the taxable year ending December 31, 1965, in an amount limited to one-half of $2,000, or $1,000.

(b) *Computation of employees' contributions.*—Existing section 72 (f)(2) of the code provides that, in the case of employees' annuities, employees' contributions include amounts contributed by the employer if such amounts would have been exempt from tax had they been paid to the employee directly. Existing law continues to apply to amounts contributed on or before December 31, 1962, for services performed on or before such date.

Subsection (b) of section 11 of the bill amends paragraph (2) of section 72(f) of the code by providing, in general, that such paragraph is not to apply to amounts which were contributed by the employer after December 31, 1962, and which would have been exempt from tax by reason of section 911 had they been paid to the employee directly. However, the preceding sentence does not apply to amounts which were contributed by the employer 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. Thus, in effect, the first sentence of the amendment contained in section 11(b) of the bill provides that an employee's basis will not be increased by reason of foreign service contributions made by an employer after December 31, 1962, and which would have been exempt from tax by reason of section 911 had they been paid to the employee directly. However, existing law would continue to apply to contributions made after December 31, 1962, to provide benefits attributable to services performed before January 1, 1963, to the extent that (1) such benefits are provided by a plan which is in existence on March 12, 1962, and (2) such contributions are required to provide the benefits set forth in the plan on March 12, 1962. Thus, certain amounts attributable to services performed before January 1, 1963, and contributed after December 31, 1962, to fund current or past service credits may be added to an employee's basis. However, to the extent benefits are initially provided after March 12, 1962, or to the extent existing benefits are increased after such date, amounts attributable to the new or increased benefits may not be added to an employee's basis even though the new or increased benefits are attributable to services performed before January 1, 1963.

(c) *Effective date.*—Subsection (c) of section 11 of the bill contains the effective date provisions applicable to the amendments to sections 911 and 72(f) of the code.

Paragraph (1) of section 11(c) of the bill provides that, except as provided in paragraph (2), the amendments made by section 11 of the bill are to apply to taxable years ending after December 31, 1962. Paragraph (2) provides that, with respect to the changes in section 911 of the code, the amendment made by section 11(a) of the bill is to apply only with respect to amounts received after December 31, 1962, and which are attributable either, as provided in subparagraph (A), to services performed after such date, or, as provided in subparagraph (B), to 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. Thus, in effect, the effective date provision, with respect to the amendment to section 911, applies existing law to amounts received after December 31, 1962, which are attributable to services performed before January 1, 1963, if on March 12, 1962, a right existed (whether forfeitable or nonforfeitable) to receive such amounts. On the other hand, if amounts are received after December 31, 1962, which are attributable to services performed before January 1, 1963, to which the recipient did not have a right in existence on March 12, 1962, section 911, as amended by section 11 of the bill, will apply to such amounts. In the event a right to receive an amount attributable to services performed before January 1, 1963, existed as of March 12, 1962, and thereafter such amount is increased, section 911, as amended by section 11 of the bill, will apply to such increase.

The application of the provisions of section 11(c)(2) of the bill may be illustrated by the following examples:

Example 1.—A, a U.S. citizen who files his returns on a calendar-year basis, is privately employed and a bona fide resident of Italy for the period January 1, 1961, through December 31, 1963. He is compensated at a rate of $25,000 per year and receives such compensation in the year it is earned. The amounts excludable from gross income for the various calendar years and the applicable provisions of section 911 of the code are as follows: for the years 1961 and 1962, $25,000 under section 911 before amendment by section 11 of the bill; for the year 1963, $20,000 under section 911, as amended by the bill.

Example 2.—A, the taxpayer described in example 1, receives on May 1, 1963, $5,000 as a supplementary salary payment for services performed during the taxable year 1962. Such amount is received pursuant to an agreement in existence on March 12, 1962. Under section 11(c)(2)(B) of the bill, such amount will be subject to section 911 of the code before amendment. The entire supplementary salary payment will be excludable from gross income under section 911(a)(1) (before amendment).

Example 3.—The facts are the same as in example 2, except that no right to receive the $5,000 supplementary salary payment is in existence on March 12, 1962. Under section 11(c)(2)(B) of the bill, such amount is to be subject to the provisions of section 911, as amended by the bill. Under section 911, as amended, the amount excludable is to be computed under section 911(c). Under section 911(c)(2), the supplementary salary payment is to be considered received in 1962. Under section 911(c)(1), that portion of the amount received which, when added to other qualifying amounts received during the taxable year 1962, does not exceed an amount computed on a daily basis at an annual rate of $20,000 will be excludable. Since, under the facts set forth in example 1, A received excludable amounts in excess of $20,000 during the taxable year 1962, no part of the supplementary salary payment is to be excludable from gross income.

SECTION 12. CONTROLLED FOREIGN CORPORATIONS

(a) *Tax on United States shareholders.*—Subsection (a) of section 12 of the bill, corresponding to section 13 of the bill as passed by the House, adds a new subpart F (secs. 951–964) and a new subpart G (secs. 970–972) to part III of subchapter N of the Internal Revenue Code of 1954.

SECTION 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES PERSONS

(a) *Amounts included.*—Subsection (a) provides that, if a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during its taxable year, then any United States person who is a United States shareholder (as defined in subsection (b)) and who owns (within the meaning of section 958(a)) stock in such corporation, on the last day of such taxable year on which it was a controlled foreign corporation must include in gross income for his taxable year (in which or with which ends the taxable year of the controlled foreign corporation) the sum of (except as provided by section 963, relating to the receipt of minimum distributions):

(1) his pro rata share of the corporation's subpart F income for its taxable year, and his pro rata share of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year; and

(2) his pro rata share of the corporation's increase in earnings invested in United States property for its taxable year which is not excluded from gross income under section 959(a)(2).

The pro rata shares are included in the income of the United States shareholder even though there may be intervening entities in a chain between the controlled foreign corporation and such shareholder. The pro rata share to be included by the United States shareholder (if the corporation is a controlled foreign corporation for its entire taxable year) is that amount which would have been distributed with respect to the ownership interest of such person if the corporation had distributed the total amount of its subpart F income, the total of its previously excluded subpart F income withdrawn from investment in less developed country corporations, and the total of the increase in its earnings invested in United States property on the last day of its taxable year. If the corporation is a controlled foreign corporation for only part of its taxable year, paragraphs (2), (3), and (4) of section 951(a) provide that the pro rata share is that which would have been distributed (on the last day of the corporation's taxable year on which it was a controlled foreign corporation) if the controlled foreign corporation had distributed pro rata an amount which bears to such total amount the same ratio that the part of the year during which the corporation was a controlled foreign corporation bears to the entire taxable year.

Example (1).—X, a United States shareholder, wholly owns throughout 1965 Y, a controlled foreign corporation, which has $50 of subpart F income, $50 of previously excluded subpart F income withdrawn from investment in less developed countries, and $100 of earnings and profits for its taxable year 1965. Both X and Y use a calendar year as their taxable year. X, for taxable year 1965, must include $100 ($50+$50) in gross income as if such amount had been distributed on December 31, 1965.

Example (2).—X and T, United States shareholders with the calendar year as a taxable year, each acquire on July 1, 1963, 30 percent of the voting stock of Y, a foreign corporation (having only one class of stock) which became, as of that day, a controlled foreign corporation. Y has no subpart F income or previously excluded subpart F income withdrawn from investment in less developed countries, has $100 of earnings and profits, and has a $100 increase in earnings invested in United States property, for its 1963 taxable year (also a calendar year). For their 1963 taxable year, X and T each must include in gross income $15, the amount which would have been distributed with respect to their stock if Y had distributed pro rata ½ of $100, or $50 on December 31, 1963.

An increase in earnings invested in United States property is included in gross income only to the extent that it exceeds the subpart F income for the current taxable year and previous taxable years, but only if such subpart F income (here used to include subpart F income previously excluded because of qualified investment in less developed countries but now withdrawn from such investment) has not already been so used as an offset or has not been actually distributed in a previous taxable year. Distributions from subpart F income and from amounts taxed under section 951(a)(1)(B) as increases in earnings invested in United States property are excluded from gross income under section 959. Rules for allocation of distributions to subpart F income, increases in earnings invested in United States property, or other earnings and profits are made under the rules of section 959(c).

In a case in which stock of a controlled foreign corporation is transferred by any person to a United States shareholder during a taxable year, if the transferor receives a distribution with respect to such stock, the acquiring shareholder, under section 951(a)(2)(B), may reduce the amount he would otherwise be required to include in gross income under section 951(a)(1)(A)(i) by the amount of such dividend. The corresponding provision of the bill as passed by the House applied only to transfers among United States persons. Section 951(a)(2)(B) also provides a limitation (not contained in the bill as passed by the House) that the reduction is only to the extent the amount of the distribution with respect to stock by the corporation does not exceed the distribution which would have been distributed with respect to such stock if the corporation had distributed an amount which bears the same ratio to subpart F income of the corporation for the taxable year as the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire year. The exclusion applies only where the dividend is paid to a person outside the chain of ownership described in section 958(a)(2) since otherwise the United States person is a United States shareholder both before and after the transfer.

Example (1).—Assume that A, a United States shareholder, owns 20 percent of the one class of stock in Z, a controlled foreign corporation, and that on July 1, 1963, immediately after receiving a $12 dividend, A transfers the stock to B, a United States shareholder. A, B, and Z use the calendar year as the taxable year. Z's entire earnings and profits for 1963 consists of $100 all of which is subpart F income. A must include in gross income the $12 dividend. B must include in his gross income for 1963, $10, computed as follows:

(*a*) The amount distributed by the controlled foreign corporation ($12÷20 percent)	$60
(*b*) Limitation on the distribution ($100×6/12)	50
(*c*) Limitation on the reduction (20 percent of $50)	10
(*d*) Amount included in gross income under section 951(a)(1)(A)(i) ($20 minus $10)	10

Example (2).—A, a United States shareholder, owns all the one class of stock of Y, a foreign corporation, which in turn owns all the one class of stock in Z which for its taxable year has $100 subpart F income. A, Y, and Z, each uses the calendar year as the taxable year. On July 1, Z distributes $100 to Y. A must include in gross income $100 of Z's subpart F income, unreduced under section 951(a)(2)(B) by the distribution by Z since A is the owner of the Z stock within the meaning of section 958(a) for the entire year.

Example (3).—The facts are the same as in example (2) except that A acquired the stock in Y from B (not in the chain of ownership described in section 958(a)(2)) on July 1, and that Z, immediately before the transfer, distributed $50 to B. Under section 951(a)(2)(B) the $100 otherwise required to be included in X's gross income is reduced by $50.

(b) *United States shareholder defined.*—Subsection (b) defines "United States shareholder" with respect to any foreign corporation to mean a United States person (as defined in section 957(d)) who owns under section 958(a), or is considered as owning under section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. Only a United States shareholder as thus defined is taxable under section 951 or is taken into account in determining whether there exists the United States ownership of a foreign corporation required to constitute it a controlled foreign corporation. The bill as passed by the House, in determining whether a corporation is a controlled foreign corporation, took into account any U.S. person who under the provisions corresponding to section 958(b) owned stock in the foreign corporation even though such person owned (under section 958(b)) less than 10 percent of the total combined voting power of all classes of stock entitled to vote in the corporation. Also, once a foreign corporation was classed as a controlled foreign corporation, the bill as passed by the House taxed a United States person who owned 10 percent of the value of the stock in the corporation, notwithstanding that his stock entailed no voting power.

Example.—H owns (under section 958(a)) 5 percent of the one class of stock of X, a controlled foreign corporation, and his wife, W, owns (under section 958(a)) 10 percent of the stock of such corporation. Under the rules of section 958(b), H is considered to own 15 percent of the stock of X and will be required to include in gross income amounts attributable to his 5 percent interest as determined under section 958(a). W will be required to include in gross income amounts attributable to her 10 percent of the stock of such corporation.

(c) *Coordination with election of a foreign investment company to distribute income.*—Subsection (c) provides that 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 is not required to include in gross income under subsection (a) for such year any income of such company. The corresponding provision of the bill as passed by the House applied only to subpart F income.

(d) *Coordination with foreign personal holding company provisions.*—Subsection (d) provides that a United States shareholder who, for a taxable year, is subject to tax under section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) on income of a controlled foreign corporation is not required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company. The corresponding provision of the bill as passed by the House (sec. 13(b)(1)) amended section 551(b) to provide that the amount of undistributed foreign personal holding company income otherwise required under section 551(b) to be included in gross income of a United States person is reduced by his proportionate share of undistributed foreign personal holding company income included in gross income under section 951(a) for the taxable year as his proportionate share of subpart F income of such controlled foreign corporation.

SECTION 952. SUBPART F INCOME DEFINED

Section 952 defines the two types of income of a controlled foreign corporation which constitute "subpart F income" and may be includible in the gross income of United States shareholders under section 951(a)(1)(A).

(a) *In general.*—Paragraph (1) of section 952(a) provides that the subpart F income of a controlled foreign corporation, for purposes of section 951(a)(1)(A), is the sum of (1) the income of the controlled foreign corporation derived from insurance of United States risks as determined under section 953; and (2) the foreign base company income of a controlled foreign corporation, as determined under section 954. The provision in the bill as passed by the House which included in subpart F income the income of the controlled foreign corporation from United States patents, copyrights, and exclusive formulas and processes has been deleted from subpart F; but see section 16 of the bill as reported by your committee for provisions relating to the transfer of such rights to a controlled foreign corporation.

(b) *Exclusion of United States income.*—Subsection (b) excludes, from subpart F income, amounts includible in gross income under chapter 1 of the code (other than the new subpart F) where the controlled foreign corporation is engaged in trade or business in the United States and such income is treated as income from sources within the United States. This subsection will not permit an exclusion from subpart F income in the case of United States source income of a controlled foreign corporation having no permanent establishment in the United States in situations (involving tax treaties) in which such permanent establishment is a requisite to imposition of United States tax, since in such a situation no amount will have been included in gross income for purposes of this section.

(c) *Limitation.*—Section 952(c), corresponding to section 952 (a)(3) of the bill as passed by the House, provides that the subpart F income of a controlled foreign corporation for any taxable year of such corporation may not exceed the earnings and profits of the controlled foreign corporation for that year but with a reduction not provided for by the bill as passed by the House. The reduction is the amount (if any) by which—

(1) the sum of the deficits in earnings and profits for prior taxable years beginning after December 31, 1959 (reduced by any earnings and profits for taxable years beginning after December 31, 1959, and before January 1, 1963), exceeds

(2) an amount equal to the earnings and profits described in section 959(c)(3) accumulated for taxable years beginning after December 31, 1962, determined as of the close of the preceding taxable year.

For such purpose a deficit for a prior taxable year is taken into account only to the extent it has not been taken into account for any preceding taxable year.

Example (1).—M, a controlled foreign corporation, has subpart F income for taxable year 1963, before applying subsection (c), of $100. Deductions not allocable to such income exceed gross income (other than gross income giving rise to subpart F income) by $25 with the result that earnings and profits for the year are $100 minus $25, or $75. M's subpart F income for 1963 as limited by subsection (c) is $75.

Example (2).—In 1963 a controlled foreign corporation has earnings and profits of $90,000, consisting of $40,000 of subpart F income and $50,000 of other income. For taxable year 1964, the corporation has a deficit in earnings and profits of $400,000. In 1965 it has earnings and profits of $380,000, consisting of subpart F income of $300,000 and other income of $80,000. It makes no distributions during 1963, 1964, or 1965. Under subsection (c), the limitation for 1965 is $30,000 computed as follows:

Earnings and profits for 1965		$380, 000
Reduced by deficit for 1964	$400, 000	
Less:		
Earnings and profits described in sec. 959(c)(3) accumulated as of close of 1964 (without reduction by the 1964 deficit)	50, 000	
		350, 000
Limitation under subsection (c)		30, 000

(d) *Special rule in case of indirect ownership.*—Subsection (d) provides a special rule that, for purposes of the limitation in subsection (c), the earnings and profits of a controlled foreign corporation for a taxable year are reduced not only by the deficits of such controlled foreign corporation as provided in subsection (c), but also by the deficits of certain other foreign corporations. The special rule is that if a United States shareholder owns (within the meaning of section 958(a)) stock of a foreign corporation and by reason of such ownership owns (within the meaning of such section) stock of any other foreign corporation, and any of such foreign corporations has a deficit in earnings and profits for the taxable year, then earnings and profits of each such foreign corporation which is a controlled foreign corporation is, with respect to such shareholder, reduced to take account of such deficit in such manner as the Secretary of the Treasury or his delegate may prescribe by regulations.

SECTION 953. INCOME FROM INSURANCE OF UNITED STATES RISKS

Section 953, corresponding to section 952(b) of the bill as passed by the House, defines the term "income derived from insurance of United States risks" referred to in section 952(a)(1) as one item included in subpart F income.

(a) *General rule.*—Subsection (a) provides that income derived from the insurance of United States risks is that income which would (subject to certain modifications) be taxed under subchapter L of chapter 1 if the controlled foreign corporation were a domestic insurance corporation. Such income is included in subpart F income, however, only if attributable to the reinsurance or the issuing of any insurance or annuity contract (A) in connection with property in or liability arising out of activity in, or in connection with the lives or health of, residents of the United States, or (B) in connection with risks which are not included in subparagraph (A) because of an arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of reinsurance or the issuing of any insurance or annuity contract in connection with property in or liability arising out of activity in, or in connection with the lives or health of, residents of the United States. The definition is the same as that in the bill as passed by the House except for changes which are clerical and which make clear that the contract must be in connection with property in or liability arising out of activity in the United States or in connection with the life or health of residents of the United States. Your committee has added a new sentence at the end of subsection (a) which provides that section 953 applies only in the case of a controlled foreign corporation which receives, during any taxable year, premiums or other consideration in respect of contracts described above in excess of 5 percent of the total premiums and other consideration received during the taxable year in respect of all reinsurance and issuing of insurance and annuity contracts.

(b) *Special rules.*—Subsection (b), which is the same, except for conforming changes, as section 952(b)(2) of the bill as passed by the House, provides special rules which modify the application of subchapter L for purposes of subsection (a).

Under paragraph (1), respecting the application of part I of subchapter L, life insurance company taxable income is defined solely as the gain from operations under section 809(b) despite the provisions of section 802(b).

Under paragraph (2), the taxable income of all insurance companies other than life insurance companies, that is, both mutual and stock insurance companies which are ordinarily subject to the provisions of part II or part III of subchapter L, respectively, is to be determined under part III of subchapter L.

Paragraph (3) disallows certain deductions from income for purposes of this subsection. These deductions are:

(A) Section 809(d)(4) (operations loss deduction),

(B) Section 809(d)(5) (certain nonparticipating contracts),

(C) Section 809(d)(6) (group life, accident, and health insurance),

(D) Section 809(d)(10) (small business deduction),

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

(F) Section 832(b)(5) (certain capital losses).

Under paragraph (4) "gross amount" (in section 809(c)(1)), net decrease in reserves (in section 809(c)(2)), "increases in certain reserves" (defined in section 809(d)(2)), and premiums earned (defined in section 832(b)(4)) are taken into account only to the extent in respect of any reinsurance or the issuing of any insurance or annuity contract described in subsection (a)(1) of section 953.

Under paragraph (5), all other items of income, that is items other than those taken into account under paragraph (4), as well as all items of expenses, losses, and deductions shall be properly allocated under regulations prescribed by the Secretary of the Treasury or his delegate.

SECTION 954. FOREIGN BASE COMPANY INCOME

(a) *Foreign base company income.*—Subsection (a), corresponding to section 952(e) of the bill as passed by the House, defines foreign base company income as the sum of three items, each reduced by deductions properly allocable to such items: (1) foreign personal holding company income, (2) foreign base company sales income, and (3) foreign base company services income. The bill as passed by the House contained no provision corresponding to item (3).

(b) *Exclusions and special rules.*—Paragraph (1) provides an exclusion from foreign base company income for (A) dividends and interest received during the taxable year from investments which at the time of receipt are qualified investments in less developed countries, or (B) gains from the sale or exchange during the taxable year of investments which at the time of sale or exchange are qualified investments in less developed countries to the extent that gains from such sales or exchanges exceed the losses from such sales or exchanges. The preceding exclusion is limited to the increase for the taxable year in qualified investments in less developed countries. The bill as passed by the House contained a provision for the reduction of foreign base company income by the amount of any increase in qualified investments in less developed countries, with different terms of qualification discussed under section 955(b).

Example.—O, a controlled foreign corporation, has for taxable year 1965 subpart F income of $100 which includes $50 of foreign base company income of which $40 consists of dividends from qualified investments in less developed countries. O's increase for the taxable year in qualified investments in less developed countries is $30. O may exclude from foreign base company income $30 under section 954(b)(1) and will, accordingly, include in gross income foreign base company income of only $20.

Paragraph (2) of section 954(b) provides that foreign base company income does not include income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or the performance of services directly related to the use of any such aircraft or vessel.

Paragraph (3), corresponding to paragraph (6) of section 952(e) of the bill as passed by the House, provides that, if the foreign base company income for the taxable year is less than 30 percent of gross income, no part of the income is to be treated as foreign base company income, but if foreign base company income for the taxable year exceeds 70 percent of gross income, the entire gross income is, subject to the provisions of paragraphs (1), (2), (4), and (5) of section 954(b), to be treated as foreign base company income. The corresponding percentages in the bill as passed by the House were 20 percent and 80 percent, respectively. The reduction of subpart F income provided by subpart G (Export Trade Corporations) does not affect the determinations of the 30 and 70 percent lines.

Paragraph (4) provides that foreign base company income does not include any item of income with respect to which it is established to the satisfaction of the Secretary of the Treasury or his delegate that the creation or organization of the controlled foreign corporation receiving such item under the laws of the country in which it is incorporated does not have the effect of substantial reduction of income, war profits, or excess profits taxes or similar taxes.

The determination of whether the creation or organization of a controlled foreign corporation has the effect of substantially reducing income, war profits, excess profits taxes or similar taxes depends upon all the facts and circumstances including the effective rate of tax and the extent to which it has been reduced.

Paragraph (5), corresponding to section 952(e)(7) of the bill as passed by the House, provides that the foreign personal holding company income, the foreign base company sales income, and the foreign base company services income are reduced, under regulations prescribed by the Secretary of the Treasury or his delegate, so as to take into account deductions (including taxes) properly allocable to such income.

(c) *Foreign personal holding company income.*—Subsection (c) is similar to section 952(e) of the bill as passed by the House, and defines foreign personal holding company income, for purposes of section 954(a)(1), as foreign personal holding company income (as defined in section 553) with the modifications and adjustments provided in paragraphs (2), (3), and (4) of section 954(c).

Paragraph (2) provides that all rents are included in foreign personal holding company income without regard to whether or not such rents constitute 50 percent or more of gross income. Section 553 already achieves such a result as to royalties.

Paragraph (3) excludes from personal holding company income (A) rents and royalties derived in the active conduct of a trade or business, (B) or dividends, interest and gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing, or similar business, or derived from the investments by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business. The exclusion applies, however, only to amounts received from a person other than a related person.

Paragraph (4) excludes certain income received from related persons:

(A) dividends and interest from a related person which (i) is organized under the laws of the same foreign country under the laws of which the controlled foreign corporation is created or organized and (ii) has a substantial part of its assets used in its trade or business located in such same foreign country;

(B) interest received in the conduct of a banking, financing, or similar business from a related person engaged in the same type of business provided the business of the payor and the recipient are predominantly with persons other than related persons; and

(C) rents, royalties, and similar amounts received from a related person for the use of, or privilege of using, property within the country under the laws of which the controlled foreign corporation is created or organized.

(d) *Foreign base company sales income.*—Paragraph (1) of subsection (d) corresponds to section 952(e)(2) of the bill as passed by the House and defines foreign base company sales income as income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with:

(1) the purchase of personal property from a related person and its sale to any person,

(2) the sale of personal property to any person on behalf of a related person,

(3) the purchase of personal property from any person and its sale to a related person, or

(4) the purchase of personal property from any person on behalf of a related person,

where (A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) 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, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

The definition does not apply to income of a controlled foreign corporation from the sale of a product which it manufactures. In a case in which a controlled foreign corporation purchases parts or materials which it then transforms or incorporates into a final product, income from the sale of the final product would not be foreign base company sales income if the corporation substantially transforms the parts or materials, so that, in effect, the final product is not the property purchased. Manufacturing and construction activities (and production, processing, or assembling activities which are substantial in nature) would generally involve substantial transformation of purchased parts or materials.

Where the definition of foreign base company sales income depends on whether property is sold for use, consumption, or disposition outside the country under the laws of which the controlled foreign corporation is created or organized, a destination test applies. Generally property will be considered to be used, consumed, or disposed of in the country to which it is delivered unless circumstances indicate that the property is to be exported after it is so delivered.

Paragraph (2) of section 954(d) provides that in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, then, under regulations prescribed by the Secretary of the Treasury or his delegate, the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation and shall constitute foreign base company sales income of the controlled foreign corporation. Determinations, such as those required under section 954 (b)(3) and (d)(1) (A) and (B), as to such branch income shall be made as though such branch were a separate controlled foreign corporation.

Paragraph (3), corresponding to the last sentence of section 952(e)(2) of the bill as passed by the House, provides that a person is a related person with respect to a controlled foreign corporation, if such a person is—

(A) an individual, trust, or estate which controls such corporation;

(B) a corporation which controls, or is controlled by, the controlled foreign corporation;

(C) a corporation which is controlled by the same person or persons which control the controlled foreign corporation.

For purposes of such paragraph, control means the ownership, directly or indirectly, of stock (determined under section 958) possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

The bill as passed by the House provided in section 952(e)(2) that foreign base company income included foreign base company sales income if, for the taxable year, such income was equal to at least 20 percent of the gross income of the foreign corporation. Your committee's amendment provides no comparable limitation with respect to foreign base company sales income but, as discussed above, it provides in section 954(a)(2) a 30-percent limitation which is applicable to total foreign base company income.

(e) *Foreign base company services income.*—Subsection (e) defines foreign base company services income as that income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which are performed—

(1) for or on behalf of a related person, and

(2) outside the country under the laws of which the controlled foreign corporation is created or organized.

Such rule, however, does not apply to income derived from services which are directly related to the sale or exchange of property manufactured, produced, grown, or extracted by the controlled foreign corporation and which are performed before the sale or exchange, or derived from services directly related to an offer or effort to sell or exchange such property.

(f) *Increase in qualified investments in less developed countries.*—Subsection (f) provides the rule for determining the increase for a taxable year in qualified investments in less developed countries. This amount constitutes a limitation on the exclusion of dividends, interest, and gains from qualified investments in less developed countries and requires, in effect, that such dividends, interest, and gains be reinvested in qualified investments in less developed countries. The increase for a taxable year is the amount by which a controlled foreign corporation's qualified investment in less developed countries at the close of its taxable year exceeds such investments at the close of the preceding taxable year.

SECTION 955. WITHDRAWAL OF PREVIOUSLY EXCLUDED SUBPART F INCOME FROM QUALIFIED INVESTMENT

(a) *In general.*—Subsection (a) provides rules relating to previously excluded subpart F income withdrawn from investment in less developed countries which is includible in gross income of a United States shareholder under section 951(a)(1)(A)(ii).

Paragraphs (1) and (2) of section 955(a) define the amount of subpart F income withdrawn from investment in less developed countries and set forth the limitations on including such amount in gross income. The amount withdrawn is an amount equal to the decrease in qualified investments in less developed countries for the taxable year provided such decrease does not exceed the sum of the amounts excluded from foreign base company income under section 954(b)(1) for all prior taxable years reduced by the sum of amounts of previously excluded subpart F income withdrawn from investments in less developed countries for all prior taxable years. Further, such decrease must be reduced by the amount (if any) by which losses exceed gains on dispositions of qualified investments in less developed countries and, after application of such losses, such decrease may not exceed the sum of earnings and profits for the current year and all prior taxable years beginning after December 31, 1962.

Example (1).—X, a United States shareholder and sole owner of M, a controlled foreign corporation, determines the amount includible in gross income under section 951(a)(1)(A)(ii) for the taxable year as follows:

(1) Decrease in qualified investments in less developed countries for the taxable year		50
(2) Excess of losses over gains on dispositions of qualified investments in less developed countries during the taxable year		10
(3) Earnings and profits for the current taxable year and all prior taxable years beginning after December 31, 1962		45
(4) Section 955(a)(1) (A) and (B) limitation: Amounts excluded from foreign base company income under section 954(b)(1) for all prior taxable years	75	
Less: amounts of previously excluded subpart F income withdrawn from qualified investments in less developed countries for all prior taxable years	25	50
(5) Amount includible in gross income under section 951(a)(1)(A)(ii) for the taxable year (item 1 reduced by item 2 to the extent not in excess of the lesser of items 3 or 4)		40

Example (2).—The facts are the same as in example (1) except that earnings and profits for the current taxable year and all prior taxable years are 35 instead of 45. The amount includible in gross income under section 951(a)(1)(A)(ii) for the taxable year is 35 (item 1 reduced by item 2 and limited by item 3 to the extent not in excess of item 4).

Example (3).—The facts are the same as in example (1) except the section 955(a)(1) (A) and (B) limitation (item 4) is 30 instead of 50. The amount includible in gross income under section 951(a)(1)(A)(ii) for the taxable year is 30 (item 1 reduced by item 2 limited by item 4 and not in excess of item 3).

Paragraph (3) provides that a United States shareholder's pro rata share of the amount of previously excluded subpart F income of a controlled foreign corporation withdrawn from investment in less developed countries for a taxable year is his pro rata share of the amount determined under paragraph (1).

(b) *Qualified investments in less developed countries.*—Subsection (b) defines qualified investments in less developed countries as property which is—

(A) stock of a less developed country corporation but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of such less developed country corporation;

(B) an obligation of a less developed country corporation which at the time of its acquisition by the controlled foreign corporation has a maturity of 5 years or more, but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation; or

(C) an obligation of a less developed country.

For purposes of this section, an obligation of a less developed country includes, wherever appropriate, obligations issued or guaranteed by the government of a less developed country or a political subdivision thereof and obligations of an agency, instrumentality or other "alter ego" of a government of a less developed country. Because of the variety of legal forms that may be involved, the provision refers only to the essential condition that a less developed country be financially committed in the obligation.

Paragraph (2) provides that property which would be a qualified investment in less developed countries but for the fact that the foreign country, after the property was acquired, ceased to be a less developed country shall be treated as a qualified investment in less developed countries.

Paragraph (3) provides that a controlled foreign corporation may, under regulations prescribed by the Secretary of the Treasury or his delegate, elect to treat qualified investments in a less developed country as acquired during the taxable year although actually acquired during the following taxable year or on or before such day after the close of the following taxable year as such regulations may prescribe.

Paragraph (4) provides that the amount taken into account with respect to property described in paragraph (1) or (2) shall be its adjusted basis, reduced by any liability to which such property is subject.

(c) *Less developed country corporations.*—Subsection (c) defines a less developed country corporation as a foreign corporation which is created or organized under the laws of a less developed country and which during the taxable year is engaged in the active conduct of one or more trades or businesses and—

(A) at least 80 percent of whose gross income for such year is derived from sources within less developed countries, and

(B) at least 80 percent in the value of whose assets on each day of the taxable year consists of—

(i) property used in such trades or businesses and located in less developed countries,

(ii) money, and deposits with persons carrying on the banking business,

(iii) stock, and obligations which, at the time of their acquisition, have at least a 5-year maturity, of any other less developed country corporation,

(iv) obligations of a less developed country,

(v) an investment required because of restrictions imposed by a less developed country, and

(vi) property described in section 956(b)(2) relating to exceptions from the term United States property.

For purposes of section 955(c)(1)(A), whether income is derived from sources within less developed countries shall be determined under regulations prescribed by the Secretary of the Treasury or his delegate.

The source rules prescribed under such regulations, to be used in determining whether income is derived from sources within one foreign country or another, need not be analagous to the rules used in determining whether or not income is derived from sources within the United States.

Paragraph (2) provides that the term "less developed country corporation" also includes a foreign corporation 80 percent or more of the assets of which on each day of the taxable year consists of assets used, or held for use, for or in connection with production of income described below and property described in section 956(b)(2), relating to exceptions from the term United States property, and 80 percent or more of the gross income of which consists of:

(A) gross income derived from, or in connection with, the using (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country, or from, or in connection with, the performance of services directly related to use of such aircraft or vessels, or from the sale or exchange of such aircraft or vessels, or

(B) dividends and interest received from foreign corporations which are less developed country corporations within the meaning of this paragraph and 10 percent or more of the total combined voting power of all classes of stock of which are owned by the foreign corporation, and gain from the sale or exchange of stock or obligations of foreign corporations which are such less developed country corporations.

The 80-percent gross income requirement can be satisfied by a combination of the amounts described in subparagraphs (A) and (B).

Paragraph (3), which is identical to section 953(b)(5) of the bill as passed by the House, except for one new rule, defines less developed country. Except for certain countries and areas specified in the paragraph which may not be designated as less developed countries, the designation of which countries are less developed is left to Executive order. The new rule is that termination of a designation of a country as a less developed country may not be made until 30 days after notice by the President to the Senate and the House of Representatives of his intention to make the termination.

SECTION 956. INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY

Section 956 provides rules for determining the amount includible in gross income under section 951(a)(1)(B) as a United States shareholder's pro rata share of the controlled foreign corporation's increase in earnings invested in United States property. A similar provision of the bill as passed by the House, section 953, applied to investments in nonqualified property which included not only United States property but also property other than that ordinary and necessary for the active conduct of an existing trade or business and other than certain investments in corporations incorporated in less developed countries and actively carrying on a trade or business almost wholly within such countries.

(a) *Determination of the amount of the investment.*—Paragraph (1) of section 956(a) provides that the amount of earnings of a controlled foreign corporation invested in United States property at the end of any taxable year is the aggregate amount of such property held at the close of the taxable year, to the extent such amount would have constituted a dividend if it had been distributed. For such purpose, however, earnings and profits does not include amounts attributable to previously excluded subpart F income withdrawn from less developed countries during the taxable year.

Paragraph (2) of section 956(a) provides that the increase for any taxable year of a United States shareholder's pro rata share of the earnings of a controlled foreign corporation invested in United States property is the amount determined by subtracting, from his pro rata share of the amount determined under paragraph (1) for the close of the taxable year, his pro rata share of the amount determined under paragraph (1) for the close of the preceding taxable year, reduced by amounts distributed during such preceding taxable year to which section 959(c)(1) applies, that is, reduced by distributed amounts which have been excluded from gross income because they are earnings and profits previously taxed as increases in earnings invested in United States property. Such determination is made on the basis of stock owned under section 958(a) on the last day during the taxable year on which the foreign corporation is a controlled foreign corporation.

Example.—X is a United States shareholder and 100-percent owner of controlled foreign corporation M. M's investment in United States property determined under section 956(a)(1) at the close of the taxable year 1964 was $150 and its accumulated earnings and profits at the beginning of the taxable year 1965 was $175, $100 of which were described in section 959(c)(1), $50 of which were described in section 959(c)(2), and $25 of which were described in section 959(c)(3). During the taxable year 1965, M had earnings and profits of $50, $35 of which were subpart F income and M withdrew $10 of previously excluded subpart F income from qualified investments in less developed countries. M distributed $50 to which section 959(c)(1) applies during the preceding taxable year 1964. The total United States property held by M at the close of the taxable year 1965 is $250. X determines the amount includible in his gross income under section 951(a)(1)(B) as follows:

(1) Amount of United States property held at the close of the taxable year 1965		$250
(2) Amount of item (1) which would have constituted a dividend if distributed (item (1) to extent not in excess of earnings and profits at December 31, 1965 of $225)		225
(3) Determination of pro rata increase in investment in United States property for the taxable year 1965:		
Amount determined under section 956(a)(1) at close of taxable year 1965	$225	
Amount determined under section 956(a)(1) at close of preceding taxable year, reduced by amounts paid to which section 959(c)(1) applies during such preceding taxable year ($150 minus $50)	100	
		125
(4) Amount includible in gross income under section 951(a)(1)(B):		
Pro rata increase in investment in United States property	125	
Less: Previously taxed subpart F income ($50 in prior years and $35 in current year) and previously excluded subpart F income withdrawn from qualified investments ($10)	95	
		30

Paragraph (3) of section 956(a) provides that the amount taken into account under paragraphs (1) or (2) with respect to any property is to be its adjusted basis, reduced by any liability to which the property is subject.

(b) *United States property defined.*—Paragraph (1) of subsection 956(b) provides the general rule that United States property means property acquired after December 31, 1962, which is tangible property located in the United States; stock of a domestic corporation; an obligation of a United States person; any right to the use in the United States of a patent or copyright, an invention, model, or design (whether or not patented), a secret formula or process, or any similar property right, which is acquired or developed by the controlled foreign corporation for use in the United States.

Paragraph (2) excepts property from United States property if it is referred to in subparagraphs (A) through (F). Subparagraph (A) refers to obligations of the United States, money, or deposits with persons carrying on the banking business. Subparagraph (B) refers to property located in the United States purchased in the United States for export to, or for use in, foreign countries. Subparagraph (C) refers to any obligation of a United States person arising in connection with the sale or processing of property, if the amount of such obligation 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 other party to such sale or processing transaction and the United States person had such transaction been made between unrelated persons.

Subparagraph (D) refers to aircraft, railroad rolling stock, vessels, motor vehicles, or containers, used in the transportation of persons or property in foreign commerce and used predominantly outside the United States. Subparagraph (E) refers to insurance company assets equivalent to the unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business with respect to

87490--62----17

contracts not described in section 953(a)(1). Subparagraph (F) refers to an amount of assets of the controlled foreign corporation equal to the earnings and profits accumulated after December 31, 1962, and excluded from gross income under section 952(b), relating to the exclusion of certain United States income.

(c) *Pledges and guarantees.*—Subsection (c) provides that a controlled foreign corporation, under regulations by the Secretary of the Treasury or his delegate, is considered to hold an obligation of a United States person if it is a pledgor or guarantor of such obligation.

SECTION 957. CONTROLLED FOREIGN CORPORATIONS; UNITED STATES PERSONS

(a) *Controlled foreign corporations defined.*—Subsection (a), corresponding to section 954(a) of the bill as passed by the House, defines controlled foreign corporation for purposes of the new subpart F, as a foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by United States shareholders (defined in section 951(b) to include only United States persons owning or considered as owning 10 percent or more of such stock) on any day during the taxable year of the corporation. In this connection, constructive rules of ownership provided in section 958 apply. The bill as passed by the House, to determine whether ownership of more than 50 percent exists in the United States, took account of any stock interest (even if less than 10 percent) owned by a United States person.

(b) *Special rule for insurance.*—Subsection (b), corresponding to section 954(b) of the bill as passed by the House, provides a special definition of controlled foreign corporations solely for the purpose of including the income derived from insurance of United States risks, referred to in section 953(a), in the gross income of a United States shareholder. Under the special definition "controlled foreign corporation" includes not only a foreign corporation satisfying subsection (a) but also one of which more than 25 percent of the total combined voting power of all classes of stock is owned under section 958 by United States shareholders, on any day during the taxable year of a corporation, if the gross amount of premiums or other consideration in respect of any reinsurance or issuing of insurance or annuity contracts described in section 953(a)(1), exceeds 75 percent of the gross amount of all premiums or other consideration in respect of all risks. Only the subpart F income consisting of income from insurance of United States risks is required to be included in the gross income of a United States person owning stock in a corporation satisfying subsection (b) but not subsection (a).

(c) *Corporations organized in United States possessions.*—Subsection (c) excepts from the definition of "controlled foreign corporation" a corporation created or organized in Puerto Rico or a United States possession. In order to qualify for the exception, the corporation must derive at least 80 percent of its gross income for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately before the end of such taxable year as may be applicable) from sources within Puerto Rico or a United States possession. In addition, 50 percent of its gross income for such period (or part thereof) must be derived from the active conduct within Puerto Rico or a United States possession of certain specified trades or businesses. The statutory language for this requirement is adapted from Puerto Rican economic incentive law and does not necessarily indicate that the activities described constitute substantial transformation for purposes of the foreign base company sales income rule. The trades or businesses constituting manufacturing or processing referred to in section 957(c)(2) will include, for example, the manufacture in the Commonwealth of Puerto Rico of tabulating cards, paper tablets or pads, facial tissues, and paper napkins from jumbo rolls of paper; the manufacture of such household products as liquid starch by mixing large quantities of the ingredients which are used to produce liquid starch; or the manufacture of fruit nectar juices and drinks from fruit concentrates.

Subsection (c) in effect leaves the corporations covered there subject to the rules of existing law. In order to insure that such corporations will not be availed of for tax haven activities, however, the Secretary of the Treasury or his delegate is given the power under the last sentence of section 957(c) to prescribe regulations as to whether the source of income is in the Commonwealth of Puerto Rico or a United States possession, or whether income is derived from the active conduct of a described trade or business in such Commonwealth or United States possession. However, such regulations will not change existing law governing the source of income which is derived from the "manufacture or processing" of goods, wares, merchandise or other tangible personal property in the Commonwealth of Puerto Rico.

(d) *U.S. person defined.*—Subsection (d), for which there was no corresponding provision in the House bill, provides that, for purposes of subpart F, the term "United States person" has the meaning assigned to it in section 7701(a)(30) except that—

(1) with respect to a corporation organized under the laws of Puerto Rico, such term does not include an individual who is a resident of Puerto Rico, if a dividend received by him during the taxable year from such corporation would, for purposes of section 933(1), be treated as income derived from sources within Puerto Rico,

(2) with respect to a corporation organized under the laws of the Virgin Islands, such term does not include an individual who is a resident of the Virgin Islands and whose income tax obligation under subtitle A for the taxable year is satisfied pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands, approved July 22, 1954 (48 U.S.C. 1642), by paying tax on income derived from all sources into the treasury of the Virgin Islands, and

(3) with respect to a corporation organized under the laws of any other possession of the United States, such term does not include an individual who is a resident of any such other possession and whose income derived from sources within possessions of the United States is not, by reason of section 931(a), includible in gross income under subtitle A for the taxable year.

The effect of paragraphs (1), (2), and (3), above, is to exclude individuals who qualify thereunder in determining whether a foreign corporation incorporated in Puerto Rico, the Virgin Islands, or another possession of the United States, as the case may be, is a controlled foreign corporation by reason of the ownership of more than 50 percent of its stock by United States shareholders (i.e., shareholders who are

United States persons) each of whom owns 10 percent or more of the stock of such foreign corporation. This determination of whether a foreign corporation is a controlled foreign corporation is made not only for purposes of subpart F, but also for purposes of section 1248 of the code, as added by section 15 of the bill, as reported by your committee. The application of sections 931(a) and 933(1) of the code and of section 28 of the Revised Organic Act of the Virgin Islands is not affected by the bill.

SECTION 958. RULES FOR DETERMINING STOCK OWNERSHIP

Section 958 is the same as section 955 of the bill as passed by the House except for conforming and clarifying changes and the addition of certain modifications to the constructive ownership rules of section 318(a) of the Code for purposes of this section.

Section 958 provides, in subsection (a), a limited rule of stock ownership for determining the amount taxable to a United States shareholder, and, in subsection (b), a broader set of constructive rules of ownership for determining whether the requisite ownership by United States shareholders exists so as to make a corporation a controlled foreign corporation or a United States shareholder has the requisite ownership to be liable for tax under section 951(a).

(a) *In general.*—For purposes of subpart F (other than sections 955(a)(1) (A) and (B), 955(c)(2)(A)(ii), and 960(a)(1)), a United States shareholder owns the stock which he owns directly in a foreign corporation and also that which he owns through certain foreign entities as follows: stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or a foreign trust or foreign estate (within the meaning of section 7701(a)(31)) is considered as proportionately owned by the shareholders, partners, or beneficiaries. Stock owned by such a foreign entity with the application of such rule is considered as actually owned by such foreign entity for again applying the rule. The rule in effect gives rise to a chain of ownership and, since the rule operates only on stock owned by a foreign entity, attribution under the rule stops with the first United States shareholder in the chain of ownership running from the controlled foreign corporation to such person. For example, W, a domestic corporation, owns 80 percent of the one class of stock of X, a foreign corporation, which in turn owns 80 percent of the one class of stock of Y, another foreign corporation, which in turn owns 90 percent of the one class of stock in Z. Under the rule, X is considered as owning 80 percent of the 90 percent which Y owns in Z, or 72 percent. 80 percent of such 72 percent, or 57.6 percent of the stock in Z, is considered as owned by W. Since W is a domestic corporation which is a United States shareholder, W is the person taxed even though W is wholly owned by U, another domestic corporation. If Z has $100 of subpart F income, then W is required to include $57.60 in gross income under section 951(a).

Paragraph (3) of subsection (a) provides, for the sole purpose of taxing United States shareholders on a foreign mutual insurance company's income derived from insurance of United States risks, that that term "stock" includes any certificate entitling the holder to voting power in the corporation.

(b) *Other provisions.*—Subsection (b) provides constructive rules of ownership based, with certain specified exceptions, on section 318. The principle to be followed in applying such rules is that they are to be applied so that the effect is to subject a United States shareholder to the requirement of section 951(a), to treat a person as a related person under section 954(d)(3) with respect to a controlled foreign corporation, or to make a corporation a controlled foreign corporation under section 957.

The specified exceptions to the rules of section 318 are as follows:

(1) No attribution of ownership from a nonresident alien individual (other than a foreign estate or trust) to a citizen or resident of the United States can occur under section 318 (a)(1)(A);

(2) In considering stock owned by a partnership, estate, trust, or corporation, as owned by the partners, beneficiaries, or shareholders, a partnership, estate, trust, or corporation which owns more than 50 percent of the total combined voting power of all classes of stock entitled to vote, is to be considered as owning all the voting power of all such classes of stock;

(3) Stock of a partner, beneficiary, or shareholder which is attributed to the partnership, estate, trust, or corporation will not be attributed to another partner, beneficiary, or shareholder;

(4) In applying the rule which requires ownership of 50 percent of the stock of a corporation before stock owned by such corporation can be attributed to its stockholders, the bill as passed by the House substituted a zero limitation for the 50-percent limitation; your committee's amendment provides that a 10-percent limitation will be substituted for the 50-percent limitation in the application of clause (i) of section 318(a)(2)(C);

(5) Your committee has also added a provision that the rule that stock owned by or for a partner or a beneficiary or a shareholder of an estate or trust or corporation shall be considered as owned by the partnership, estate, or trust or corporation will not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person, nor will a corporation be considered as owning stock owned by or for a 50 percent or more shareholder where the effect is to consider a United States person as owning stock which is owned by a person who is not a United States person.

Example (1).—M, N, and O, all United States persons, each own 20 percent of the stock in X, a foreign corporation having only one class of stock, which in turn owns 60 percent of the stock in Y, also a foreign corporation having only one class of stock. For the purpose of attributing the stock owned by X in Y to M, N, and O, X is considered as owning all of the stock of Y with the result that M, N, and O are considered as each owning 20 percent of the stock of Y.

Example (2).—A, an owner of 50 percent of the one class of stock in Y, owns 8 percent of the one class of stock in Z, a controlled foreign corporation; B (not related to A), the owner of the other 50 percent of the stock in Y, owns 45 percent of the one class of stock of Z. A is considered as owning no part of the stock in Z which is owned by B. Thus, A does not own 10 percent or more of the stock of Z so as to be required under section 951(a) to include in gross income any amount of income of Z.

Example (3).—M, N, and O, all United States persons, each own 30 percent of the stock in X, a foreign corporation having only one class of stock, which in turn owns 40 percent of the stock in Y, also a foreign corporation having only one class of stock. Under the provisions of section 958(b)(4), M, N, and O are each considered as owning 12 percent of the stock of Y.

SECTION 959. EXCLUSION FROM GROSS INCOME OF PREVIOUSLY TAXED EARNINGS AND PROFITS

Section 959, except for conforming changes, is the same as section 956 of the bill as passed by the House.

(a) *Exclusion from gross income of United States persons.*—Subsection (a) provides that earnings and profits of a foreign corporation attributable to amounts once included in gross income under section 951(a) are not again included in gross income when actually distributed. The exclusion is applicable whether the income included in gross income under section 951 was required to be included by reason of direct ownership of stock in a controlled foreign corporation or ownership through a chain of ownership described in section 958(a). Further, the exclusion applies with respect to the United States shareholder who owned stock in a foreign corporation at the time it was included in gross income under section 951(a), or with respect to a successor in interest who can at the time of the actual distribution provide such proof as the Secretary of the Treasury or his delegate by regulations require that he holds the interest of the United States shareholder who previouslly included in gross income the earnings and profits being distributed.

Example.—On December 31, 1963, X, a United States shareholder, owns 20 shares of the 100 shares of the only class of stock in Z, a controlled foreign corporation, and by reason of such ownership includes $20 in gross income under section 951 (his proportionate share of Z's $100 of subpart F income which constituted Z's entire earnings and profits for its 1963 taxable year). On January 31, 1964, X transfers 9 shares of his stock in Z to Y. On June 1, 1964, X receives an $11, and Y a $9, distribution from Z. Neither the $11 received by X nor the $9 received by Y is includible in gross income.

Subsection (a) in conjunction with section 951(a)(1)(B) also prevents including in gross income under section 951(a)(1)(B) any increase in earnings invested in United States property to the extent such increase can be considered as attributable income taxable under section 951(a)(1)(A). Subpart F income thus provides an offset to prevent the inclusion in gross income of emounts otherwise includible as an increase in earnings invested in United States property. For example, Z, a controlled foreign corporation wholly owned by X, a domestic corporation, has $40 subpart F income, and a $50 increase in earnings invested in United States property; X includes in gross income only $10 of the $50 because $40 of such $50 is offset by the $40 of subpart F income included in X's gross income.

(b) *Exclusion from gross income of certain foreign subsidiaries.*—Subsection (b) provides that, for purposes of section 951(a), income of a controlled foreign corporation once included in gross income of a United States shareholder is not, when distributed to another controlled foreign corporation, included in any of such other foreign corporation's income which must be taxed to such United States shareholder or his successor in interest. For example, X, a domestic corporation, wholly owns Y, a controlled foreign corporation which in turn wholly owns Z, another controlled foreign corporation. In 1970, Y has no income except that which is received from Z, which has \$100 of income which X is required to include in gross income under section 951. Such \$100, although paid to Y as a dividend in 1970, is not included in the income of Y which must be included in the gross income of X, even though such a dividend would ordinarily constitute subpart F income. The same result follows whether the dividend is paid in 1970 or a later year so long as under the rules of subsection (c) it is allocated to earnings and profits under paragraphs (1) and (2) which were once included in X's gross income under section 951.

(c) *Allocation of distributions.*—Subsection (c) provides rules for the allocation of distributions to earnings and profits. Amounts included in gross income of a shareholder under section 951(a) do not constitute distributions for purposes of reducing the earnings and profits of the controlled foreign corporation. Accordingly, when the controlled foreign corporation makes an actual distribution, thereby reducing its earnings and profits, it is necessary at the shareholder level to identify whether the distribution is from earnings and profits attributable to amounts already included in gross income of the shareholder under section 951(a) (in which case the distribution is not taxable as a dividend) or is from earnings and profits which are attributable to amounts not so taxed (in which case the distribution is taxable as a dividend). Under subsection (c), earnings and profits attributable to amounts once taxed (described in paragraphs (1) and (2)) are to be considered to be distributed until they are exhausted (first from the current year and next from past years). Subsequent distributions, after the earnings and profits described in paragraphs (1) and (2) have been received by a shareholder, are taxable as dividends to the extent of the remaining earnings and profits.

A shareholder is not taxable on a distribution which is out of earnings and profits described in paragraph (1) (relating to earnings invested in United States property) or paragraph (2) (relating to subpart F income). The separate classification of earnings and profits under paragraphs (1) and (2) is for purposes of computing a United States shareholder's pro rata share of the increase in earnings in United States property under section 956. For purposes of section 956(a)(2)(A), the amount of earnings invested in United States property for a taxable year is reduced by earnings so invested which were actually distributed. For this purpose, paragraph (1) of section 959(c) provides that earnings and profits attributable to investment in United States property are the first earnings and profits considered as distributed to a shareholder.

In this connection, although amounts taxed once under section 951(a)(1)(A) may offset amounts representing an increase in earnings in United States property under section 951(a)(1)(B) (so as to avoid taxing the same earnings twice) such offset does not affect the amount of earnings and profits attributable to amounts representing the increase in earnings in United States property for purposes of paragraph (1). The amount of earnings and profits under paragraph (1) includes earnings and profits attributable to amounts includible in gross income under section 951(a)(1)(B) as well as earnings and profits attributable to amounts which would have been included under such section except for the availability of the offset by reason of the inclusion of amounts under section 951(a)(1)(A). Earnings and profits attributable to amounts included in income under section 951(a)(1)(A), but used to offset an increase in earnings invested in United States property are not, however, included in paragraph (2) since they are already included in paragraph (1). Thus, there is no duplication in the amounts attributable to paragraphs (1) and (2), and, from the standpoint of the shareholder, the amount of earnings and profits allocable to him under paragraphs (1) and (2) is always equal to the amount of income he has been taxable on under section 951(a) (and for which he has not received an actual distribution).

Example.—M, a controlled foreign corporation, is organized on January 1, 1963, and is solely owned by X, a United States shareholder. Both M and X use the calendar year as a taxable year. M's earnings and profits for 1963 are $200, $100 of which is subpart F income. (M's income included $25 excluded under section 954(b)(1) as dividends, interest, and gains invested in qualified investments in less developed countries.) M's total United States property at the end of 1963 is $50 and M makes a distribution during 1963 of $20. The division of M's earnings and profits account at December 31, 1963, for the purpose of determining the tax on X, is as follows:

Sec. 959(c)(1) amounts ($50 increase in U.S. property less $20 distribution)	$30
Sec. 959(c)(2) amounts ($100 subpart F income less $50 used as offset to increase in investment in U.S. property and reclassified as a sec. 959(c)(1) amount)	50
Sec. 959(c)(3) amounts (the remaining earnings and profits after reduction for sec. 959(c) (1) and (2) amounts—$200 minus $20 (actual distribution) minus $30 (U.S. property) minus $50 (subpart F income))	100
Total earnings and profits at Dec. 31, 1963	180

X is required to include $100 in gross income under section 951(a)(1)(A)(i) and he would have been required to include $50 in gross income under section 951(a)(1)(B) but for section 959(a)(2) which allows the offset of previously taxed subpart F income (whether in the current year or in prior years) against increases in investments in United States property. X may exclude the $20 distribution from gross income under section 959(a)(1) since under section 959(c) such distribution is considered to be out of amounts described in section 959(c)(1).

In 1964, M's earnings and profits are $300, $75 of which is subpart F income. M has no change in investments in United States property and withdraws $15 of previously excluded subpart F income from qualified investments in less developed countries. M makes a distribution of $250 during 1964.

M's earnings and profits account, at December 31, 1964, for purposes of section 959(c) is as follows:

Sec. 959(c)(1) amounts ($30 accumulation from prior years less distributions but not in excess of total current and accumulated sec. 959(c)(1) amounts or $30)	0
Sec. 959(c)(2) amounts ($50 accumulation from prior years plus current subpart F income of $75 and withdrawals of previously excluded subpart F income from qualified investments of $15 less distributions but not in excess of total current and accumulated sec. 959(c)(2) amounts or $140)	0
Sec. 959(c)(3) amounts ($100 accumulation from prior years, plus current earnings and profits not classified under sec. 959(c) (1) or (2) of $225, less withdrawals of previously excluded subpart F income from qualified investments of $15, less distributions not out of sec. 959(c) (1) and (2) amounts of $80)	$230
Total earnings and profits at Dec. 31, 1964	230

X is required to include $75 in gross income under section 951(a)(1)(A)(i) and $15 under section 951(a)(1)(A)(ii). X may exclude $170 of the $250 distribution from gross income under the provisions of section 959(a)(1); $80 is includible in gross income as a dividend.

(d) *Distributions excluded from gross income not to be treated as dividends.*—Except for deeming foreign taxes paid by foreign corporations as being paid by a domestic corporation in special cases discussed below, a distribution excluded from gross income under section 959 is treated as a distribution which is not a dividend.

SECTION 960. SPECIAL RULES FOR FOREIGN TAX CREDIT

A domestic corporation owning stock in a controlled foreign corporation is required to include in its gross income, under the provisions of subpart F, income of such foreign corporation, whether or not the foreign corporation is one or more links removed in a chain of ownership. Therefore, section 902 (relating to credit for corporate stockholder in foreign corporation) which depends on actual distributions would not operate to give the domestic corporation a credit for foreign taxes paid by the controlled foreign corporation. Section 960 provides rules, consistent with section 902, for treating foreign taxes paid by controlled foreign corporations on income which is included in the gross income of domestic corporations under section 951(a) as having been paid by such domestic corporations. Section 960 corresponds to section 957 of the bill as passed by the House.

(a) *Taxes paid by a foreign corporation.*—Subsection (a) applies to a domestic corporation which includes in gross income under section 951(a) an amount attributable to earnings and profits of a foreign corporation at least 10 percent of the voting stock of which is directly owned by such domestic corporation, or of a foreign corporation at least 50 percent of the voting stock of which is owned by a foreign corporation at least 10 percent of the voting stock of which in turn is directly owned by the domestic corporation. If the directly owned corporation is a less developed country corporation as defined in section 902(d), then the domestic corporation is deemed to have paid the same proportion of the income, war profits, and excess profits taxes paid (or deemed paid) by the controlled foreign corporation to a foreign country or possession of the United States for the taxable year which the amount of the earnings and profits of the foreign corporation so included in gross income of the domestic corporation bears to the sum of the entire earnings and profits of such foreign corporation for such taxable year and the total amount of such income, war profits, and excess profits taxes paid by such foreign corporation.

Example 1.—X, a domestic corporation, wholly owns Y, a foreign corporation, which is a less developed country corporation, which in turn wholly owns Z, another foreign corporation. X, Y, and Z each use the calendar year as a taxable year. For 1963, X is deemed to have paid taxes actually paid by Y and Z as follows:

	X	Y	Z
Earnings and profits plus foreign taxes		100	100
Earnings and profits		60	80
Foreign taxes		40	20
Subpart F income		30	50
Gross income under sec. 951 (30+50)	80.00		
Foreign taxes deemed paid by X under sec. 960 (a):			
$\left(\frac{30}{100}\times 40\right)$	12.00		
$\left(\frac{50}{100}\times 20\right)$	10.00		

If the directly owned corporation is not a less developed country corporation, then the domestic corporation is deemed to have paid the same proportion of the total income, war profits, and excess profits taxes paid by the controlled foreign corporation to a foreign country or possession of the United States for its taxable year which the amount of the earnings and profits of the foreign corporation included in gross income of the domestic corporation bears to the entire earnings and profits of such foreign corporation for such taxable year. The taxes so deemed paid by the domestic corporation under section 960(a)(1)(C) if the directly owned corporation is not a less developed country corporation are included in the gross income of the domestic corporation under section 78 of the code (as added by sec. 9 of the bill).

Example (2).—X, a domestic corporation, wholly owns Y, a foreign corporation not a less developed country corporation, which in turn wholly owns Z, another foreign corporation. X, Y, and Z each use the calendar year as a taxable year. For 1963, X is deemed to have paid taxes actually paid by Y and Z as follows:

	X	Y	Z
Earnings and profits		60	80
Foreign taxes		40	20
Subpart F income		30	50
Gross income under sec. 951 (30+50)	80.00		
Foreign taxes deemed paid by X under sec. 960(a)(1)(C) and included in gross income under sec. 78:			
$\left(\frac{30}{60}\times 40\right)$	20.00		
$\left(\frac{50}{80}\times 20\right)$	12.50		

If a domestic corporation receives a distribution any part of which is excluded from gross income under section 959, the foreign taxes which are deemed to have been paid under section 960(a) are not again deemed paid under section 902. Other foreign taxes which are not deemed paid under section 960 because paid, for instance, by a first-tier corporation, through which profits of a second-tier corporation are distributed (after having been taxed for a prior year under section 951 to a United States shareholder which is a corporation), will still be deemed paid under section 902 when an actual distribution is made. A distribution of such profits, although excluded under section 959(a), is treated by the domestic corporation as a dividend solely for taking into account under section 902 such foreign taxes as were not deemed paid under section 960.

Example (3).—Suppose that the $50 of subpart F income of Z taxed to X in 1963 in examples (1) and (2) above was in 1970 distributed to Y who received no other income for such year, and that Y paid a tax of $20 for 1970 and distributed the remaining $30 to X before the end of 1970. In such case, although such $30 is excluded from gross income under section 959(a), it is treated as a dividend under section 902 so that for 1970, X is deemed to have paid $12 in foreign taxes under example (1), or $20, under example (2).

If income of a first-tier foreign corporation required to be included in the gross income of a domestic corporation under section 951(a) includes a dividend from a second-tier foreign corporation to the first-tier corporation, then section 902(b) applies to foreign taxes paid by the second-tier corporation and not already allowed as a credit in order to deem them paid by the first-tier foreign corporation so that under section 960(a) they will be deemed paid by the domestic corporation.

Example (4).—M, a domestic corporation, wholly owns N, a controlled foreign corporation, which is a less developed country corporation, which in turn wholly owns O, also a controlled foreign corporation but which has no income required to be included in any United States shareholder's gross income. For taxable year 1970, O pays $40 in foreign taxes. O pays to N as a dividend its total earnings and profits of $60 for such taxable year, which dividend is N's only income and which in N's hands is foreign base company income required to be included in M's gross income under section 951(a). N has no deductions and pays no foreign taxes. Applying section 902(b) N is deemed to have paid $24 in foreign taxes and M is in turn deemed to have paid $24 under section 960. If N were not a less developed country corporation, N and in turn M, would be deemed to have paid $40.

(b) *Special rules for foreign tax credit on receipt of previously taxed earnings and profits.*—Where a taxpayer receives a distribution which is excluded from income under section 959 because it was once taxed as income included in gross income of a United States shareholder under section 951(a), the section 904 limitation is increased in the year of actual distribution so that a credit will be allowed for foreign taxes imposed on the income distributed after it was included in gross income under section 951. The taxpayer, however, must have either chosen the foreign tax credit in the taxable year in which such income was included in gross income under section 951(a), or have paid or accrued in such year no income, war profits, or excess profits taxes to any foreign country or possession of the United States. He must also choose the foreign tax credit in the year of the receipt of the excluded distribution.

The amount of the increase in the section 904 limitation is an amount equal to the increase in such limitation which occurred in the taxable year of the inclusion of the income under section 951(a) solely by reason of such inclusion. Such amount is then reduced by the foreign taxes which were allowed as a credit in such year of the inclusion but which would not have been allowable but for such inclusion. The increase in the section 904 limitation may not exceed the income, war profits, or excess profits taxes paid, or deemed paid, or accrued with respect to the distribution in the taxable year such distribution is received.

Under paragraph (3) of section 960(b), a taxpayer who chose to take a foreign tax credit in the taxable year in which he was required to include income in gross income under section 951(a), but does not choose to take a foreign tax credit in the taxable year in which such income is actually received, may not deduct under section 164 any income, war profits, or excess profits taxes paid or accrued on such income.

Under paragraph (4) of section 960(b), if the increase in limitation exceeds the U.S. tax for the taxable year, the excess is deemed an overpayment of tax for such year.

SECTION 961. ADJUSTMENTS TO BASIS OF STOCK IN CONTROLLED FOREIGN CORPORATION AND OF OTHER PROPERTY

Section 961 is the same as section 958 of the bill as passed by the House except for the changes made necessary by the addition of section 962, relating to an election by individuals to be subject to tax at corporate rates.

(a) *Increase in basis.*—Subsection (a) provides that the basis of a United States shareholder's stock in a controlled foreign corporation, and of property by reason of which he is treated as owning such stock in determining the amount which he must include in gross income under section 951, is increased by the amount included in gross income under section 951. Your committee has added a provision to subsection (a) that in the case of a United States shareholder who has made an election under section 962 for the taxable year, the increase in basis shall not exceed an amount equal to the amount of tax paid under chapter 1 with respect to the amounts required to be included in his gross income under section 951(a).

Example (1).—X, who owns stock in corporation M with a basis of $1,000, includes $50 of M's income in gross income as required under section 951(a). The basis of X's stock in M is increased to $1,050.

Example (2).—The facts are the same as in example (1) except that X is also required under section 951(a) to include in gross income $60 of the income of corporation N, a controlled foreign corporation wholly owned by M. In such case the basis of X's stock in M is increased to $1,110.

Example (3).—Y, an individual United States shareholder who owns stock in corporation O with a basis of $1,000, and who would have included $70 in gross income under section 951(a), makes an election under section 962, and pays $15 in U.S. tax under chapter 1 of the code. The basis of Y's stock in corporation O is increased to $1,015.

(b) *Reduction in basis.*—Subsection (b) provides that the basis of stock or other property with respect to which a United States shareholder receives an amount which is excluded from gross income under section 959(a) is reduced by such amount. Your committee has added a provision to subsection (b) that in the case of a United States shareholder who has made an election under section 962 for any prior taxable year, the reduction in basis shall not exceed an amount equal to the amount received which is excluded from gross income under section 959(a), relating to the exclusion of previously taxed earnings and profits, after the application of section 962(d), relating to actual distributions of earnings and profits attributable to amounts with respect to which an election was made under section 962. Thus, if X, in example (2) above, received a distribution of $110 which was excluded from gross income under section 959(a) as the income previously taxed in such example, the basis of X's stock in Y would be reduced again to $1,000. If Y, in example (3) above, received a distribution of $70, his basis in the stock of corporation O would be reduced by $15, that is, the amount excluded from gross income under section 959(a) after the application of section 962(d).

Subsection (b)(2) provides that to the extent that an amount excluded from gross income under section 959(a) exceeds the adjusted basis of stock or other property with respect to which it is received, such excess shall be treated as gain from the sale or exchange of the property.

SECTION 962. ELECTION BY INDIVIDUALS TO BE SUBJECT TO TAX AT CORPORATE RATES

Section 962 provides an election for an individual United States shareholder to be subject to tax at corporate rates instead of individual rates with respect to amounts included in his gross income under section 951(a).

(a) *General rule.*—Subsection (a) provides that in the case of a United States shareholder who is an individual and who elects to have the provisions of section 962 apply for the taxable year, the tax imposed under chapter 1 of the Code on amounts included in gross income under section 951(a), relating to amounts included in gross income of United States shareholders, shall be an amount equal to the tax which would be imposed under section 11 of the Code, relating to tax imposed on corporations, if such amounts were received by a domestic corporation. Subsection (a) further provides that, for purposes of applying the provisions of section 960, relating to foreign tax credit, the amounts included in gross income under section 951(a) with respect to which an election is made under section 962, shall be treated as if they were received by a domestic corporation.

Example.—X, an individual and sole shareholder of controlled foreign corporation M (not a less developed country corporation), is required to include $70,000 (the entire earnings and profits of M Corporation for the taxable year) in gross income under section 951(a) and makes an election under section 962 to be subject to tax at corporate rates. (M Corporation is the only controlled foreign corporation in which X is a United States shareholder.) Both X and M use the calendar year as a taxable year. M Corporation paid $30,000 of foreign tax in connection with earning the $70,000 of income referred to above. The limitation on tax under section 962(a) is equal to the corporate tax less any foreign tax credit to which a corporation would be entitled. Thus, the tax would be computed as follows:

Income included in gross income under sec. 951(a) with respect to which election under sec. 962 is made	$70,000
Foreign tax deemed paid under sec. 960(a) (included in gross income under new sec. 78) $\left(\frac{\$70,000}{\$70,000}\times \$30,000\right)$	30,000
Taxable income under sec. 11 of code	100,000
Tax at 52 percent	52,000
Less tax attributable to surtax exemption	5,500
Tax	46,500
Less foreign tax credit	30,000
U.S. tax liability (limitation under sec. 962(a))	16,500

(b) *Election.*—Subsection (b) provides that an election to have the provisions of section 962 apply for any taxable year shall be made by a United States shareholder at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe by regulations and that an election made for any taxable year may not be revoked except with the consent of the Secretary of the Treasury or his delegate.

(c) *Surtax exemption.*—Subsection (c) provides that, for purposes of applying subsection (a)(1), the surtax exemption provided by section 11(c) of the Code shall not exceed an amount which bears the same ratio to $25,000 as the amounts included in a United States shareholder's gross income under section 951(a) for the taxable year bears to his pro rata share of the earnings and profits for the taxable year of all controlled foreign corporations with respect to which he included any amount in gross income under section 951(a).

Example.—X, an individual United States shareholder owning 60 percent of controlled foreign corporations N and O, makes an election under section 962 for the taxable year and includes in gross income for such year under section 951(a) $20,000 with respect to corporation N and $10,000 with respect to corporation O. Corporation M has $100,000 and corporation N has $50,000 earnings and profits for the taxable year. X's surtax exemption is computed as follows:

$$\frac{20,000+10,000}{60,000+30,000}\times 25,000=8,333.33$$

(d) *Special rules for actual distributions.*—Paragraph (1) of section 962(d) provides that the earnings and profits of a foreign corporation attributable to amounts which were included in the gross income of a United States shareholder under section 951(a) and with respect to which an election under section 962 applied shall, when such earnings and profits are distributed, notwithstanding the provisions of section 959(a)(1), relating to the exclusion from gross income of actual distributions of previously taxed earnings and profits, be included in gross income to the extent that such earnings and profits so distributed exceed the amount of tax paid on the amounts to which such election applied.

Example.—X, an individual and sole shareholder of controlled foreign corporation M (not a less developed country corporation), was required to include $70,000 (the entire earnings and profits of M Corporation for the taxable year) in gross income under section 951(a) for the taxable year 1963, and $30,000 (the amount of foreign taxes paid by M Corporation for such year), and made an election under section 962 to be subject to tax at corporate rates. X paid $16,500 in U.S. tax on such amount with the application of section 962(a). In 1964, X received an actual distribution of the $35,000 from M Corporation. Notwithstanding the provisions of section 959(a)(1), X is required to include $26,750 in gorss income for the taxable year 1964 ($35,000 minus $8,250).

SECTION 963. RECEIPT OF MINIMUM DISTRIBUTIONS BY DOMESTIC CORPORATIONS

This section provides that if a given percentage, termed a minimum distribution, of the earnings and profits of a controlled foreign corporation is received by a domestic corporate shareholder of such foreign corporation, the domestic corporation may elect to exclude from its gross income for such taxable year the amount of subpart F income of such foreign corporation otherwise includible in gross income of the domestic corporation under section 951(a)(1)(A)(i). In addition to the elective treatment accorded domestic corporate shareholders with respect to subpart F income of controlled foreign corporations in which stock is owned directly, domestic corporate shareholders may elect with respect to foreign corporations in a chain of corporations or with respect to all controlled foreign corporations in which the domestic corporate shareholder owns stock directly or stock owned indirectly through interests in foreign corporations, foreign partnerships, foreign trusts or foreign estates. The required minimum distribution of earnings and profits by a foreign corporation is inversely proportional to the effective foreign tax rate of the controlled foreign corporation with respect to which an election is made, or the consolidated earnings and profits and consolidated effective foreign tax rate of a chain of foreign corporations, or a group of controlled foreign corporations, with respect to which an election is made. Thus, as the effective foreign tax rate increases, the required minimum distribution of earnings and profits decreases. The inverse proportion is intended to result in a distribution which will give rise to sufficient United States tax to make the overall taxes of the recipient roughly approximate the United States rate.

(a) *General rule.*—Subsection (a) of section 963 sets forth the general rule that subpart F income of a controlled foreign corporation will not be included in the gross income of a United States shareholder, as defined in section 951(b), if (1) the United States shareholder is a domestic corporation; (2) the domestic corporate shareholder (A) receives a minimum distribution, as defined in section 963(b), of the earnings and profits for the taxable year from a controlled foreign corporation in which stock is owned directly, within the meaning of section 958(a)(1)(A); or, (B) to the extent the domestic corporate shareholder elects, receives a minimum distribution with respect to the consolidated earnings and profits for the taxable year of foreign corporations in a chain of corporations as described in section 963(c)(2); or, (C) the domestic corporate shareholder receives a minimum distribution, as defined in section 963(b), with respect to a group of foreign corporations as described in section 963(c)(3); and (3) the domestic corporate shareholder consents to all the regulations prescribed by the Secretary of the Treasury or his delegate under section 963 prior to the last day prescribed by section 6072 for filing its income tax return. The exclusion from gross income under this section is limited to subpart F income of. controlled foreign corporations, as defined in section 952, which would otherwise be includible in gross income under section 951(a)(1)(A)(i).. This section (which is concerned with current earnings and profits) does not apply to previously excluded subpart F income withdrawn from investment in less developed country corporations includible in gross income under section 951 (a)(1)(A)(ii) or increase in earnings invested in United States property includible in gross income under section 951(a)(1)(B) (both of which are measured by current and certain accumulated earnings and profits).

(b) *Minimum distributions.*—Subsection (b) of section 963 establishes a schedule of required minimum distributions of earnings and profits as a percentage of total earnings and profits. If a domestic corporate shareholder elects to apply this section to a single controlled foreign corporation as provided in subsection (a)(1), the required minimum distribution is determined by the effective foreign tax rate, determined in accordance with the provisions of subsection (d), of the controlled foreign corporation. Thus, if the controlled foreign corporation was subject to an effective foreign tax rate of 15 percent, for this elective section to apply, the controlled foreign corporation would be required to distribute, as a dividend, an amount equal to 80 percent of its earnings and profits for the taxable year of the foreign corporation ending with or within the taxable year of the electing domestic corporate shareholder. If a domestic corporate shareholder elects to apply this section to a chain of foreign corporations as provided in subsection (a)(2), the required minimum distribution is determined as a percentage of the consolidated earnings and profits of foreign corporations in the chain, to the extent elected, and the effective foreign tax rate is determined, in accordance with the provisions of subsection (d)(2), for all foreign corporations for which the election is applicable. In like manner, if a domestic corporate shareholder elects to have this section apply to all controlled foreign corporations as provided in subsection (a)(3), the required minimum distribution of earnings and profits for the taxable year is determined as a percentage of the consolidated earnings and profits of all such controlled foreign corporations, and all foreign corporations through which, within the meaning of section 958(a)(2), the domestic corporate shareholder is considered to own stock in a controlled foreign corporation, and the effective foreign tax rate is determined, in accordance with the provisions of subsection (d)(2), for all foreign corporations for which the election is applicable.

(c) *Amounts to which section applies.*—Subsection (c) of section 963 describes the controlled foreign corporation, or combination of controlled foreign corporations, in a corporate organization for which a minimum distribution of earnings and profits for a taxable year will permit a domestic corporate shareholder to elect to exclude from gross income the subpart F income of such controlled foreign corporation or corporations. Paragraphs (1), (2), (3), and (4) of section 963(c) provide for alternative applications of this section of the bill.

Paragraph (1) of section 963(c) provides that subsection (a) may apply in the case of a controlled foreign corporation in which a domestic corporate shareholder owns stock directly. Thus, application of section 963 may be limited to a single first-tier controlled foreign corporation, to two or more first-tier controlled foreign corporations, or to all first-tier controlled foreign corporations in which a domestic corporation is a United States shareholder.

Paragraph (2) of section 963(c) provides that subsection (a) may apply to a controlled foreign corporation in which a domestic corporation owns stock directly and to a controlled foreign corporation in which the domestic corporation, within the meaning of section 958(a)(2), is considered to be the owner of stock through a foreign corporation, foreign partnership, or a foreign trust or foreign estate. However, if a domestic corporate shareholder elects with respect to a controlled foreign corporation below the first tier of foreign corporations, the earnings and profits of each foreign corporation through which the domestic corporate shareholder is considered to be the owner of stock in the controlled foreign corporation must be taken into account in determining if a required minimum distribution of consolidated earnings and profits had been made, whether or not such intermediate foreign corporations are controlled foreign corporations.

Paragraph (3) of section 963(c) provides that subsection (a) may apply to all controlled foreign corporations in which the domestic shareholder owns stock directly or is considered to own stock within the meaning of section 958(a)(2). Consistent with paragraph (2), the earnings and profits of all foreign corporations through which the domestic corporate shareholder is considered to own stock in controlled foreign corporations is taken into account in determining if a required minimum distribution had been made whether or not such intermediate for ign corporation is a controlled foreign corporation.

Subparagraph (A) of section 963(c)(4) provides for the exception of earnings and profits of certain less developed country corporations in determining if the required minimum distribution of subsection (b) has been made. The less developed country corporations which may be excluded are all such less developed country corporations other than those through which the United States shareholder is considered to own stock of other foreign corporations which are not less developed country corporations. If the election is made all less developed country corporations described in the preceding sentence must be excluded from the determination.

Subparagraph (B) of section 963(c)(4) provides that foreign branches of a domestic corporate shareholder may, at the election of such shareholder, be treated, under regulations prescribed by the Secretary of the Treasury or his delegate, as 100-percent owned controlled foreign corporations, which, for purposes of this section, will be considered to have distributed to the electing domestic corporate shareholder all of the earnings and profits attributable to such foreign branches. For purposes of this subparagraph, a branch of a domestic corporation will be considered a foreign branch if it is located in a foreign country or in the Commonwealth of Puerto Rico or a possession of the United States. However, a branch located in Puerto Rico or a possession of the United States will be taken into account under subparagraph (B) only if (1) such branch would be considered a controlled foreign corporation, if it were incorporated under the laws of Puerto Rico or such possession of the United States, as the case may be, and (2) the gross income of the electing domestic corporate shareholder, for the year of election, includes gross income derived from sources within Puerto Rico and possessions of the United States. Except as provided in the preceding sentence, an election to have subparagraph (B) apply may be made by a domestic corporation only with respect to all its foreign branches.

Generally speaking, a foreign branch is a permanent organization maintained in a foreign country to engage in the active conduct of a trade or business. The income of a branch is that produced by the business activities separately conducted by it.

Subparagraph (C) of section 963(c)(4) provides that, if a domestic corporate shareholder which is a United States shareholder so elects, the consolidated earnings and profits of controlled foreign corporations as provided in subsection (a)(3) shall not include any amount with respect to the earnings and profits of any controlled foreign corporation if it is established to the satisfaction of the Secretary of the Treasury or his delegate that the earnings and profits of such controlled foreign corporation could not have been distributed to United States shareholders who own stock, directly or through foreign corporations, foreign partnerships, or foreign estates or trusts, in such controlled foreign corporation because of currency or other restrictions or limitations imposed under the laws of any foreign country.

The application of the provisions of section 963(c) may be illustrated by the following example:

Example.—Domestic corporation M owns 5 percent of the voting stock of foreign corporation A, and 100 percent of the voting stock of foreign corporations B and C respectively. Foreign corporation C owns 100 percent of the voting stock of foreign corporation D, which owns 50 percent of the voting stock of foreign corporation E. The voting stock of foreign corporation F is owned 50 percent by foreign corporation E and 30 percent by foreign corporation B. None of the foreign corporations are less developed country corporations as defined in section 955(c). Assume that all corporations use the calendar year as a taxable year. Corporations A and E are not controlled foreign corporations.

Under section 963(a)(1), corporation M may elect to determine if a minimum distribution of earnings and profits has been made with respect to the earnings and profits of corporation B, corporation C, or both corporations B and C; and thereby exclude from gross income subpart F income of corporation B, corporation C, or both corporations B and C, as the case may be, if a minimum distribution had been received. Corporation M would be required to include in gross income its pro rata share of the subpart F income of controlled foreign corporations D and F.

In the alternative, corporation M may elect under section 963(a)(2) to consolidate the earnings and profits of corporations C and D, or corporations B, C, D, E, and F; and, if the required minimum distribution is received from corporation C with respect to the consolidated earnings and profits of corporations C and D, or from corporations B and C with respect to the consolidated earnings and profits of corporations B, C, D, E, and F, corporation M may exclude from gross income subpart F income of corporations C and D or corporations B, C, D, and F, as the case may be.

As another alternative, corporation M may elect under section 963 (a)(3) to determine if a minimum distribution of earnings and profits has been made with respect to the earnings and profits of corporations B, C, D, E, and F. If the required minimum distribution is received from corporations B and C with respect to the consolidated earnings and profits of corporations B, C, D, E, and F, corporation M may exclude from gross income subpart F income of corporations B, C, D, and F.

(d) *Effective foreign tax rate.*—Subsection (d) of section 963 defines the term "effective foreign tax rate" as used in section 963(b).

Paragraph (1) of section 963(d) establi hes the rule for determining the effective foreign tax rate of a single controlled foreign corporation in determining if a minimum distribution has been received by a domestic corporate shareholder as required in the case of a distribution from a controlled foreign corporation to which section 963(a)(1) applies. In such a case, the effective foreign tax rate is the percentage that income, war profits, or excess profits taxes paid or accrued to foreign countries by the controlled foreign corporation on or with respect to the earnings and profits of such corporation for the taxable year of such corporation ending in or with the taxable year of the electing domestic corporate shareholder, bears to the sum of the earnings and profits of such corporation for such period and the income, war profits, and excess profits taxes paid or accrued with respect to such earnings and profits. For example, if a controlled foreign corporation had profits before foreign income taxes of $100,000, and paid foreign income taxes of $20,000, the effective tax rate would be 20 percent ($20,000/$100,000). In cases where the amount of foreign income taxes payable by the corporation varies depending upon whether or not profits are distributed by the foreign corporation, the effective foreign tax rate is determined without regard to distributions made by the controlled foreign corporation. For example, assume foreign corporation A is incorporated in country X and derives all its income from within country X. Assume also, that country X levies an income tax of 50 percent on undistributed profits and 15 percent on distributed profits. Assume further that corporation A derived before tax income of $100,000, distributed $50,000, and paid foreign income tax of $32,500 (50 percent of $50,000 undistributed income and 15 percent of $50,000 distributed income). Although corporation A only paid an effective tax rate of 32½ percent, it will be deemed to have paid an effective foreign tax rate of 50 percent for purposes of section 963. If country X had levied a tax of 25 percent on undistributed profits and an additional 15-percent withholding tax on distributed profits, although the foreign tax paid would have been the same, $32,500 or 32½ percent, the effective foreign tax rate will be deemed to be 25 percent for purposes of section 963.

Paragraph (2) of section 963(d) establishes the rule for determining the effective foreign tax rate if the earnings and profits of two or more foreign corporations are consolidated under section 963(a) (2) or (3). In such cases, the effective foreign tax rate is the percentage that income, war profits, or excess profits taxes paid or accrued to any foreign country by the foreign corporations whose earnings and profits are consolidated with respect to the total earnings and profits of such corporations for taxable years of such corporations ending in or with the taxable year of the electing domestic corporate shareholder, bears to the sum of the earnings and profits of such corporations for such periods and the income, war profits, and excess profits taxes paid or accrued with respect to such earnings and profits to any foreign country.

(e) *Special rules.*—Paragraph (1) of section 963(e) provides that distributions made by a foreign corporation in the first 60 days of any taxable year shall be treated as having been paid from the earnings and profits of the preceding taxable year or years of the foreign corporation. In addition, the Secretary of the Treasury or his delegate may by regulations provide a period in excess of 60 days in lieu of such 60-day period.

Paragraph (2) of section 963(e) permits a domestic corporate shareholder of a controlled foreign corporation who elects the provisions of this section to treat the receipt of a subsequent distribution with respect to the foreign corporation or foreign corporations to which the election applies as having been made for, and received in, the taxable year of the United States shareholder for which the domestic corporate shareholder applied the provisions of this section of the bill. For example, if a domestic shareholder received a distribution of 50 percent of the earnings and profits of controlled foreign corporation A for taxable year 1963 (the required minimum distribution of earnings and profits if the effective foreign tax rate was 40 percent), and it was determined in 1965 that the effective foreign tax rate was 30 percent, subsequent distributions equal to an additional 10 percent of 1963 earnings and profits (the required minimum distribution of earnings and profits is 60 percent if the effective foreign tax rate is 30 percent) may, if made at a time and in a manner prescribed by the Secretary of the Treasury or his delegate, be treated, for purposes of chapter 1, as having been made by the foreign corporation in taxable year 1963 and as having been received by the electing domestic corporate shareholder in its taxable year with or in which the 1963 taxable year of the controlled foreign corporation ended. The distribution will result in additional tax owing in 1963 and interest will be payable on that additional tax for the time it has been owing.

Paragraph (3) of section 963(e) provides that an affiliated group of corporations which are eligible to make a consolidated return under section 1501 for the taxable year may elect to be treated as a single United States shareholder for purposes of section 963.

The application of this provision of your committee bill may be illustrated by the following example involving domestic corporations M and N and foreign corporations A and B. Corporation A is a wholly owned subsidiary of corporation M and corporation B is a wholly owned subsidiary of corporation N. Corporation A had earnings and profits for taxable year 1963 of $100, none of which was subpart F income, after payment of foreign income tax of $120 (an effective foreign tax rate of 55 percent). Corporation B had earnings and profits for taxable year 1963 of $100, all of which was subpart F income, after payment of foreign income tax of $15 (an effective foreign tax rate of 13 percent). Corporation M received a distribution of $40 from corporation A and corporation N received a distribution of $60 from corporation B. Corporations M and N file a consolidated return with respect to income tax imposed by chapter 1. Corporations M and N elected, under the provisions of section 963(e)(3), to be treated as a single United States person for purposes of determining if a minimum distribution of the consolidated earnings and profits of corporations A and B had been received. Since the consolidated effective foreign tax rate of corporations A and B was 40 percent (the percentage that foreign tax paid ($135) bears to the sum of earnings and profits ($200), and foreign taxes paid ($135)), and corporations M and N, treated as a single shareholder, received 50 percent of the consolidated earnings and profits of corporations A and B ($100 distributed out of consolidated earnings and profits of $200), the subpart F income of corporation B is excluded from the consolidated gross income of corporations M and N.

(f) *Regulations.*—Subsection (f) of section 963 provides that the Secretary of the Treasury or his delegate shall prescribe such regulations as the Secretary of the Treasury may deem necessary to carry out the provisions of this section of the bill. Such regulations may include, among other provisions, the establishment of special rules for the determination of the amount of foreign tax credit allowable an electing domestic corporate shareholder in the case of distributions with respect to the earnings and profits of two or more foreign corporations.

Thus, special rules for the determination of the amount of foreign tax credit allowable an electing domestic corporate shareholder (including an affiliated group of corporations electing to be treated as a single U.S. shareholder) in the case of distributions with respect to the earnings and profits of a chain of foreign corporations or of brother-sister controlled foreign corporations, may be established under regulations prescribed by the Secretary of the Treasury or his delegate. The application of the provisions of this subsection may be illustrated by the following examples:

Example (1).—Assume domestic corporation M owns 100 percent of the stock of controlled foreign corporation A, which owns 100 percent of the stock of controlled foreign corporation B. All corporations use the calendar year as a taxable year. In 1963 corporation A had earnings and profits of $75 after payment of foreign income tax of $75 (a 50-percent rate). Corporation B, for taxable year 1963, had earnings and profits of $120 after payment of foreign income tax of $30 (a 20-percent rate). The consolidated effective foreign tax rate of corporations A and B was 35 percent (total tax paid over consolidated earnings and profits plus total tax paid—105/300) and required a minimum distribution of 60 percent of the consolidated earnings and profits of corporations A and B—$117 ($195×60%). Corporation M received a distribution of $117 from corporation A, which amount was includible in gross income as a dividend. Corporation M elects to consolidate under section 963(c)(2). Corporation M's tax liability under this chapter is determined as follows:

Amount includible in gross income as a dividend	$117.00
Amount included in gross income under sec. 78 (foreign tax paid with respect to $117 based upon the consolidated effective foreign tax rate of corporations A and B (117/195×105))	63.00
Total amount included in gross income	180.00
Tentative U.S. tax (at 52-percent rate)	93.60
Foreign tax credit based upon consolidated effective foreign tax rate of 35 percent (117/195×105)	63.00
Net U.S. tax	30.60

Example (2).—Domestic corporation M owns 100 percent of the stock of foreign corporations A and B. All corporations use the calendar year as a taxable year. In 1963 corporation A had earnings and profits of $80 after payment of foreign income tax of $120 (a 60-percent rate). Corporation B, for taxable year 1963, had earnings and profits of $100 with respect to which no foreign income tax had been paid. The consolidated effective foreign tax rate of corporations A and B was 40 percent (total tax paid over consolidated earnings and profits plus total tax paid—120/300) and required a minimum distribution of \$90 (\$180×50 percent). Corporation M received a distribution of \$80 from corporation A and \$10 from corporation B, which amounts were includible in gross income as a dividend. Corporation M elects to consolidate under section 963(c)(3). Corporation M's tax liability under this chapter is determined as follows:

Amount includible in gross income as a dividend	\$90
Amount included in gross income under sec. 78 (foreign tax paid with respect to \$90 based upon the consolidated effective foreign tax rate of corporations A and B (90/180×120))	60
Total amount included in gross income	150
Tentative U.S. tax (at 52-percent rate)	78
Foreign tax credit based upon consolidated effective foreign tax rate of 40 percent (90/180×120)	60
Net U.S. tax	18

SECTION 964. MISCELLANEOUS PROVISIONS

Section 964 provides the regulatory authority necessary for the administration of subpart F and subpart G.

(a) *Earnings and profits.*—Under subsection (a), the earnings and profits of a foreign corporation and the deficit in earnings and profits for a taxable year shall be determined according to rules substantially similar to those applicable to domestic corporations under regulations prescribed by the Secretary of the Treasury or his delegate.

(b) *Blocked foreign income.*—Subsection (b) provides that under regulations prescribed by the Secretary of the Treasury or his delegate no part of earnings and profits shall be included in earnings and profits under sections 952, 955, and 956, if it is established to the satisfaction of the Secretary of the Treasury or his delegate that such part could not be distributed by the controlled foreign corporation to United States shareholders because of currency restrictions or limitations imposed under the laws of a foreign country. Such rule applies in either a case where the United States shareholder directly owns (see sec. 958(a)(1)(A)) the stock, or in case he indirectly owns (see sec. 958(a)(1)(B)) the stock and the restrictions apply at some point in the chain of ownership.

(c) *Records and accounts of United States shareholders.*—Subsection (c) provides that the Secretary of the Treasury or his delegate may by regulations require a United States shareholder or a person who has been a United States shareholder to maintain such records and accounts as such regulations prescribe as necessary to carry out the provisions of subpart F and subpart G. Such regulations may provide that the maintenance and furnishing of such records and accounts by one person may satisfy the requirement as to all United States shareholders otherwise required to furnish records and accounts with respect to a controlled foreign corporation.

Subpart G.—Export Trade Corporations

This subpart, for which there is no corresponding provision in the bill as passed by the House, provides generally that the export trade income, as defined in section 971(b), constituting foreign base company income of a controlled foreign corporation which is an export trade corporation, as defined in section 971(a), shall reduce the subpart F income of such corporation to the extent of such corporation's increase in investment in export trade assets, as defined in section 971(c). Limitations on this reduction are provided in section 970(a), based on the relationship of the export trade income to export promotion expenses or on the gross receipts from export trade income of the corporation. Section 970(b) provides for an inclusion in gross income of amounts by which subpart F income was previously reduced to the extent of a decrease in investment in export trade assets. Section 972 provides for the consolidation of groups of export trade corporations. Nothing in the new subpart G affects the authority of the Secretary of the Treasury or his delegate to apply the provisions of section 482 relating to allocation of income and deductions among taxpayers.

SEC. 970. REDUCTION OF SUBPART F INCOME OF EXPORT TRADE CORPORATIONS

(a) *Export trade income constituting foreign base company income.*—Subsection (a) of section 970 provides that the subpart F income of a controlled foreign corporation, as defined in section 957, which for the taxable year is an export trade corporation, as defined in section 971(a), shall be reduced by an amount equal to so much of the export trade income, as defined in section 971(b), of such corporation for such year as constitutes foreign base company income, as defined in section 954. However, the amount by which subpart F income is reduced is limited to the lesser of (1) an amount provided in subparagraph (A) of section 970(a)(1); (2) an amount provided in subparagraph (B) of section 970(a)(1); or (3) an amount provided in paragraph (2) of section 970(a). Paragraph (1) of section 970(a) also provides that subpart F income of a controlled foreign corporation is to be determined without regard to subpart G. Thus, the amount of foreign base company income of a controlled foreign corporation, for purposes of section 954(b)(3), is determined without regard to the amount by which subpart F income is reduced under section 970.

Subparagraph (A) of section 970 provides that the amount by which subpart F income may be reduced under section 970 may not exceed an amount equal to 1½ times so much of the export promotion expenses, as defined in section 971(d), of the export trade corporation for the year as is properly allocable to the export trade income of such corporation which constitutes foreign base company income for such year.

Subparagraph (B) of section 970(a)(1) provides, as an alternative limitation, that the amount by which subpart F income may be reduced under section 970 may not exceed an amount equal to 10 percent of so much of the gross receipts for the taxable year accruing to the export trade corporation from the sale, installation, operation, maintenance, or use of property in respect of which the export trade corporation derived export trade income which is properly allocable to export trade income which constituted foreign base company income for such year. If the gross receipts attributable to the sale, installation, operation, maintenance, or use of export property arises from commissions, fees, or other compensation received by an export trade corporation for its services, the amount upon which the 10-percent limitation applies is the amount upon which the commission, fee, or other compensation is computed.

The allocations with respect to export trade income which constitute foreign base company income under subparagraphs (A) and (B) shall be made under regulations prescribed by the Secretary of the Treasury or his delegate.

In addition to the alternative limitations provided in paragraph (1) of section 970(a), paragraph (2) of section 970(a) establishes an overall limitation that provides that the reduction under paragraph (1) for any taxable year shall not exceed an amount which bears the same ratio to the increase in the investments in export trade assets of an export trade corporation for its taxable year as the export trade income which constitutes foreign base company income of the export trade corporation for the taxable year bears to the entire export trade income of such corporation for such year.

The application of the provisions of this subsection may be illustrated by the following examples:

Example (1).—Corporation A, a 100-percent owned subsidiary of domestic corporation M, purchased products manufactured by corporation M in the United States from corporation M and resold such products to unrelated persons for use outside the foreign country in which corporation A was incorporated. For taxable year 1963, the entire operations of corporation A consisted of this activity. In such year, it purchased goods from corporation M for $1,000 and sold the goods for $2,000. Corporation A derived gross income of $1,000, incurred export promotion expenses of $300 with respect to such sales, paid foreign income taxes of $50, and derived export trade income of $650, all of which constituted foreign base company income. Corporation A, in 1963, had an increase in investment in export trade assets of $100. The limitation on the amount by which subpart F income is reduced with respect to export trade income which constitutes foreign base company income as provided in section 970(a), is $100, the lesser of (1) the export trade income which constitutes foreign base company income ($650); (2) 1½ times the export promotion expenses properly allocable to export trade income which constitutes foreign base company income ($450 (150 percent of $300)); (3) 10 percent of gross receipts from the sale of property from which corporation A derived export trade income which is properly allocable to export trade income which constitutes foreign base company income ($200 (10 percent of $2,000)); or (4) the increase in investment in export trade assets ($100). Corporation M would include $550 of subpart F income of corporation A in gross income in accordance with the provisions of section 951(a)(1)(A)(i).

Example (2).—Controlled foreign corporation A, a 100-percent owned subsidiary of domestic corporation M, in taxable year 1965 had net income of $100 and qualified as an export trade corporation. Corporation A derived export trade income of $75, of which $60 was foreign base company income. The remaining $25 of net income, which was not export trade income, was subpart F income. The

$60 of export trade income which constituted foreign base company income was less than 1½ times the export promotion expenses of $100 of corporation A for the taxable year properly allocable to such income and less than 10 percent of gross receipts of $1,000 from the sale, installation, operation, maintenance, or use of property in respect of which corporation A derived export trade income which constituted foreign base company income. The total increase in investment in export trade assets was $40. Corporation M is required to include $53 subpart F income of corporation A in gross income for taxable year 1963, which amount is computed as follows:

(i) Tentative subpart F income of corporation A ($60 which is also export trade income plus $25 which is not export trade income) $85

(ii) Amount by which subpart F income is reduced under sec. 970(a):

(*a*) Export trade income which reduces subpart F income before application of the sec. 970(a)(2) limitation (item (1), (2), or (3), whichever is the lesser):

(1) Export trade income which is foreign base company income $60

(2) 150 percent of export promotion expenses properly allocable to the amount described in (1) (sec. 970(a)(1)(A)) 150

(3) 10 percent of gross receipts from the sale of property from which the amount described in (1) was derived (sec. 970(a)(2)(B)) 100

(*b*) Section 970(a)(2) limitation:

The percentage of the increase in investment in export trade assets which export trade income which constitutes foreign base company income bears to total export trade income

$\$40 \times \frac{\$60}{\$75} =$ 32

Amount of export trade income which reduces subpart F income (item (a) or (b) whichever is lesser) 32

(iii) Subpart F income includible in gross income of corporation M (item (i) minus item (ii)) 53

(b) *Inclusion of certain previously excluded amounts.*—Subsection (b) of section 970 provides that each United States shareholder, as defined in section 951(b), who is a shareholder in a controlled foreign corporation that was an export trade corporation in any prior taxable year, must include in his gross income, under section 951(a)(1)(A)(ii), as an amount to which section 955 applies, an amount equal to his pro rata share of the decrease in investments in export trade assets of the controlled foreign corporation for such year. The United States shareholder's pro rata share of a decrease is includible in gross income under section 970(b), however, only to the extent of—

(1) the excess of the United States shareholder's pro rata share of the sum of the reductions for all previous years in subpart F income by reason of section 970(a) and section 972 (relating to the treatment of two or more corporations as a single corporation), over

(2) all inclusions in his gross income under section 951(a)(1)(A)(ii) with the application of section 970(b) for all previous years.

Example.—Assume that for 1963 Z, a controlled foreign corporation, having $100 in export trade income of which $40 is subpart F income, has an increase in investment in export trade assets of $100 and reduces its subpart F income by $40 under section 970(a) (with the application of the sec. 970(a)(2) overall limitation which is also $40).

Assume that for 1964 Z has a $50 decrease in investment in export trade assets. Y, a United States shareholder, who wholly owns Z, must include $40 in gross income under subsection (b) as his pro rata share of the decrease in investments in export trade assets.

(c) *Investments in export trade assets.*—Subsection (c) of section 970 establishes the rules for determining if, for a taxable year of a controlled foreign corporation, there has been an increase in investments in export trade assets for purposes of section 970(a), or a decrease in investments in export trade assets for purposes of section 970(b).

Paragraph (1) of section 970(c) provides that the amount taken into account with respect to any export trade asset will be its adjusted basis, reduced by any liability to which the asset is subject.

Paragraph (2) of section 970(c) provides that the amount of increase in investments in export trade assets of a controlled foreign corporation for any taxable year, for purposes of section 970(a), is the amount by which the amount of such investments at the close of the taxable year exceeds the amount of such investments at the close of the preceding taxable year.

Paragraph (3) of section 970(c) provides that the amount of decrease in investments in export trade assets of a controlled foreign corporation for any taxable year, for purposes of section 970(b), is the amount by which the amount of such investments at the close of the preceding taxable year, reduced by an amount equal to the amount of the net loss sustained during the taxable year with respect to export trade assets, exceeds the amount of such investments at the close of the taxable year.

Paragraph (4) of section 970(c) provides that a United States shareholder of an export trade corporation may, under regulations prescribed by the Secretary of the Treasury or his delegate, make the determinations under paragraphs (2) and (3) of section 970(c) as of the close of the 75th day after the close of the years referred to in such paragraphs in lieu of on the last day of such years. It is also provided that such an election made for any taxable year shall apply to such year and to all succeeding taxable years unless the Secretary of the Treasury or his delegate consents to the revocation of such election.

SECTION 971. DEFINITIONS

Section 971 defines the terms export trade corporation, export trade income, export trade assets, export promotion expenses, export property, and unrelated person for purposes of subpart G of subchapter N of chapter 1.

(a) *Export trade corporation.*—Subsection (a) of section 971 defines the term "export trade corporation" for purposes of subpart G.

Paragraph (1) of section 971(a) establishes the general rule that a controlled foreign corporation, as defined in section 957, is an export trade corporation if for the three calendar year period immediately preceding the close of the taxable year of such corporation, the corporation (1) derived 90 percent or more of its gross income from sources without the United States, as determined in accordance with the provisions of sections 861 through 863, and (2) 75 percent or more of the gross income of such corporation constituted income in respect of which the controlled foreign corporation derived export trade income, as defined in section 971(b). However, for taxable years of a controlled foreign corporation ending less than three calendar years after taxable years of such corporation beginning after December 31, 1962, 90 percent or more of the gross income of such corporation must be derived from sources without the United States, and 75 percent or more of the gross income of such corporation must have constituted income in respect of which the controlled foreign corporation derived export trade income, for taxable years of the corporation beginning after December 31, 1962.

Paragraph (2) of section 971(a) provides a special rule in the case of controlled foreign corporations if 50 percent or more of the gross income of such a corporation, for the period specified in section 971(a)(1)(A), constituted income in respect of which the controlled foreign corporation derived export trade income in respect of agricultural products grown in the United States. In such cases, a controlled foreign corporation is considered an export trade corporation without regard to the fact 75 percent or more of the gross income of such corporation does not constitute income in respect of which the controlled foreign corporation derived export trade income.

(b) *Export trade income.*—Subsection (b) of section 971 defines the term "export trade income" for purposes of subpart G.

Paragraph (1) of section 971(b) includes within the definition of export trade income, net income of a controlled foreign corporation derived from the sale of export property, as defined in section 971(e), by the controlled foreign corporation to an unrelated person, as defined in section 971(f), for use, consumption, or disposition outside the United States. The export trade income derived from the sale of export property may consist of other than foreign base company sales income, as defined in section 954(d). For example, goods may be purchased by the export trade corporation from an unrelated person and sold to an unrelated person, or if purchased from a related person, the goods may be sold to an unrelated person for use, consumption, or disposition within the country in which the export trade corporation is incorporated. In addition to net income derived from the purchase and resale of property manufactured, produced, grown, or extracted in the United States, export trade income includes net income from commissions, fees, compensation, or other income of a controlled foreign corporation (1) derived from the performance of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in connection with the sale of export property to an unrelated person for use, consumption, or disposition outside the United States or (2) derived in connection with the installation or maintenance of such property.

Paragraph (2) of section 971(b) includes within the definition of export trade income, net income of a controlled foreign corporation derived from commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services performed by the controlled foreign corporation in connection with the use by an unrelated person outside the United States of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property acquired or developed and owned by the United States manufacturer, producer, grower, or extractor of export property, but only if the controlled foreign corporation derived export trade income (as defined in sec. 971(b)(1)) from the sale of such property.

Paragraph (3) of section 971(b) includes within the definition of export trade income, net income of a controlled foreign corporation derived from the furnishing of technical, scientific, or engineering services to unrelated persons to the extent income from such services is attributable to the use of export property in the rendition of the services. If income from the rendition of technical, scientific, or engineering services is not solely attributable to the use of export property, and the amount attributable to export property cannot be established by reference to transactions between unrelated persons, the amount of export trade income will be deemed to be that percentage of total gross income received by the controlled foreign corporation from such services as the cost of the export property consumed in the rendition of such services, including a reasonable allowance for depreciation, bears to the total cost attributable to such service income. For example, assume a machine produced in the United States was sold to a customer in Germany. Controlled foreign corporation A contracted to furnish technical services to the German user with respect to the United States manufactured machine and a similar machine manufactured in Germany. The entire commission allocable to servicing the United States manufactured machine would be export trade income. If corporation A used replacement parts manufactured in the United States in servicing the German manufactured machine, corporation A would derive export trade income in the percentage of the commission allocable to servicing the German machine as the cost of the United States replacement parts used in furnishing the service bears to total cost and expenses of furnishing the services.

Paragraph (4) of section 971(b) includes within the definition of export trade income, interest income received by a controlled foreign corporation on evidences of indebtedness executed by unrelated persons in connection with payment for purchases of export property for use, consumption, or disposition outside the United States, or in connection with the payment for services described in sections 971(b) (2) and (3).

(c) *Export trade assets.*—Subsection (c) of section 971 defines the term "export trade assets" for purposes of subpart G to include (1) working capital reasonably necessary for the production of export trade income; (2) inventory of export property held for use, consumption, or disposition outside the United States; (3) facilities located outside the United States for the storage, handling, transportation, packaging, or servicing of export property; and (4) evidences of indebtedness executed by unrelated persons in connection with payment for purchases of export property for use, consumption, or disposition outside the United States, or in connection with services described in section 971(b) (2) and (3). For purposes of paragraph (2) of section 971(c), inventory of an export trade corporation will constitute export property held for use, consumption, or disposition outside the United States, even if such property is in the United States pending shipment. For purposes of paragraph (3) of section 971(c) a facility used for the manufacture or production of property will not be considered to be used for the purpose of handling export property, even though export property may be used or consumed in production or become a component part of a manufactured article.

(d) *Export promotion expenses.*—Subsection (d) of section 971 defines the term "export promotion expenses," as used in section 970(a)(1), to include all ordinary and necessary expenses paid or incurred by a controlled foreign corporation which are reasonably allocable to the receipt or production of export trade income. Expenses so allocable include, but are not limited to, a reasonable allowance for salaries or other compensation for personal services actually rendered for the purpose of producing export trade income, rentals or other payments for the use of property actually used for the purpose of producing export trade income, and a reasonable allowance for the exhaustion, wear, and tear of property actually used for the purpose of producing export trade income. However, no expense incurred within the United States will be treated as an export promotion expense unless at least 90 percent of all salaries incurred for the production of export trade income, 90 percent of rents and other payments for the use of property used for producing export trade income, 90 percent of depreciation allowances on property used in the production of export trade income, and 90 percent of all other ordinary and necessary expenses reasonably allocable to the production of export trade income, are paid or incurred outside the United States. For this purpose, salary expenses will be considered paid or incurred at the place where the employment is performed, and rents, depreciation and other expenses related to property will be considered incurred at the place where the property is located.

(e) *Export property.*—Subsection (e) of section 971 defines the term "export property" for purposes of subpart G to include any property manufactured, produced, grown, or extracted in the United States, or any interest in such property.

(f) *Unrelated person.*—Subsection (f) of section 971 defines the term "unrelated person" for purposes of subpart G to mean a person other than a related person as defined in section 954(d)(3).

SEC. 972. CONSOLIDATION OF GROUP OF EXPORT TRADE CORPORATIONS

Section 972 provides that a United States shareholder, as defined in section 951(b), of a controlled foreign corporation which is an export trade corporation, may, under regulations prescribed by the Secretary of the Treasury or his delegate, treat as a single controlled foreign corporation, for purposes of subparts F and G of subchapter N, (1) such controlled foreign corporation, (2) all controlled foreign corporations which are export trade corporations if 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned by such controlled foreign corporation, and (3) all controlled foreign corporations which are export trade corporations if 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned by controlled foreign corporations described in item (2).

(b) *Technical and clerical amendments.*—Subsection (b) of section 12 of the bill makes conforming changes.

(c) *Effective date.*—Subsection (c) of section 12 of the bill provides that the amendments made by section 12 are to apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders in which or with which such taxable years of such corporations end.

SECTION 13. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY

(a) *In general.*—Paragraph (1) of section 13(a) of the bill adds a new section 1245 to the 1954 Code. In general, the new section provides for the inclusion in gross income (as ordinary income) of the gain from the disposition of certain depreciable property, to the extent of depreciation deductions taken in periods after December 31, 1961, which are reflected in the adjusted basis of such property.

SECTION 1245. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY

(a) *General rule.*—Paragraph (1) of section 1245(a) provides the general rule that if "section 1245 property" is disposed of, the amount by which the lower of "recomputed basis" or the amount realized (or the fair market value in transactions in which no amount is realized) exceeds the adjusted basis of the property is to be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. The term "disposed of" includes any transfer or involuntary conversion. The bill as passed by the House provided that paragraph (1) applies only to dispositions after the enactment of the Revenue Act of 1962. The bill as reported by your committee provides that paragraph (1) applies only to dispositions during taxable years beginning after December 31, 1962.

Paragraph (2) of section 1245(a), under the bill as passed by the House, defined "recomputed basis" as the adjusted basis of the property recomputed by adding thereto all adjustments, for taxable years beginning after December 31, 1961, reflected in such adjusted basis on account of deductions for depreciation, or for amortization under section 168, whether in respect of the same or other property and whether allowed or allowable to the taxpayer or any other person. Your committee amendments provide that such adjustments shall be added thereto for all periods after December 31, 1961. For example, if a taxpayer, who reports his income on the basis of a fiscal year ending November 30, purchases section 1245 property on January 1, 1962, at a cost of $10,000 and the taxpayer takes depreciation deductions of $2,000 (the amount allowable) before making a gift of the property to his son on October 31, 1962, the son's adjusted basis in the property for purposes of determining gain would, under the provisions of sections 1015 (relating to the basis of property acquired by gift) and 1016 (relating to adjustments to basis), be the same as his father's adjusted basis ($8,000), and the recomputed basis of the property in the son's hands would be $10,000 since the $2,000 of depreciation deductions taken by the father are reflected in the son's basis in the property. Thus, if the son later sells the property, during a taxable year of the son beginning after December 31, 1962, for $10,000, he would have $2,000 of gain to which section 1245(a) applies. Moreover, if the son himself takes $1,000 in depreciation deductions (the amount allowable) with respect to the property and then sells it for $10,000, he would have $3,000 of gain to which section 1245(a) applies.

While recomputed basis is determined with respect to adjustments to basis for deductions for depreciation (and for amortization under sec. 168) which were either allowed or allowable, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for any taxable year was less than the amount allowable, the amount to be added for such taxable year is the amount allowed. For example, assume that in the year 1967 it becomes necessary to determine the recomputed basis of property, the adjusted basis of which reflects an adjustment of $1,000 with respect to depreciation deductions allowable for the calendar year 1962. If the taxpayer can establish by adequate records or other sufficient evidence that he had been allowed a deduction of only $800 for 1962, then in determining the recomputed basis, the amount added to adjusted basis with respect to the $1,000 adjustment to basis for 1962 will be only $800.

Paragraph (1) of section 1245(a) further provides that gain is to be recognized notwithstanding any other provision of subtitle A of the 1954 Code. Thus, other nonrecognition sections of the code are overridden by the new section. For example, the gain under such paragraph (1) would be recognized to a corporation in the case of a distribution of section 1245 property by it to a shareholder, notwithstanding the provisions of section 311(a) or 336. Likewise, gain under such paragraph (1) would be recognized to a corporation on a sale or exchange of such property, notwithstanding the provisions of section 337. The operation of section 1245 may, however, be affected by the taxpayer's method of accounting. For example, the gain from a disposition to which section 1245 applies may be reported by the taxpayer under the installment method if such method is otherwise available under section 453 of the code. For another example, section 1245 does not require recognition of gain or loss upon normal retirement of an asset in a multiple asset account as long as the taxpayer's method of accounting, in accordance with Treasury regulations, does not require recognition of such gain or loss and clearly reflects income.

In the case of a disposition of section 1245 property in which an amount is realized (a sale, exchange, or involuntary conversion), the gain to which section 1245(a) applies is the amount by which the amount realized or the recomputed basis, whichever is lower, exceeds the adjusted basis of the property. In the case of any other disposition, the gain to which section 1245(a) applies is the amount by which the fair market value of the property on the date of disposition or its recomputed basis, whichever is lower, exceeds its adjusted basis. For example, if section 1245 property has an adjusted basis of $2,000 and a recomputed basis of $3,300 and is sold for $2,900, the gain to which section 1245(a) applies is $900 ($2,900 minus $2,000). If the property is sold for $3,700, the gain is $1,700, of which $1,300 ($3,300 minus $2,000) is gain to which section 1245(a) applies. If, on the other hand, the property is distributed by a corporation to a stockholder in a distribution to which section 1245(a) applies and at a time when the fair market value of the property is $3,100, the gain recognized to the corporation upon such disposition is $1,100 ($3,100 minus $2,000); if the fair market value is $3,800 at the time of such disposition, the gain to which section 1245(a) applies is $1,300 ($3,300 minus $2,000).

Paragraph (3) of section 1245(a) defines "section 1245 property." Section 1245 property is any property (other than livestock) of a type described in subparagraph (A) or (B) of such paragraph (3) which is or has been property of a character subject to the allowance for depreciation provided in section 167. Even though the property may not be subject to the allowance for depreciation in the hands of the taxpayer, such property is nevertheless subject to the provisions of section 1245(a) if the property was subject to the allowance for depreciation in the hands of any prior holder, and if such depreciation is taken into account in determining the adjusted basis of the property in the hands of the taxpayer.

The definition of "section 1245 property" is similar in certain respects to the definition of "section 38 property" contained in section 48(a) (relating to the investment credit). However, section 1245 property is a broader concept than section 38 property, since (for example) the definition of section 1245 property is not subject to the minimum useful life provision in section 48(a)(1) or to the other limitation and exclusion provisions in paragraphs (2) through (5) of section 48(a). Moreover, the term "personal property" in subparagraph (A) of section 1245(a)(3) is intended to include not only "tangible personal property" referred to in section 48(a)(1)(A) but also intangible personal property.

Subparagraph (B) of section 1245(a)(3) describes other property (not including a building or its structural components) if such other property is tangible and has an adjusted basis in which there are reflected adjustments for depreciation or amortization under section 168 which would be taken into account in determining recomputed basis for a period in which such property (or other property) either (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 such activities. The language in clauses (i) and (ii) in section 1245(a)(3)(B) is intended to have the same meaning as when used in clauses (i) and (ii) in section 48(a)(1)(B) (relating to the definition of sec. 38 property subject to the investment credit). Even though the property is not used by the taxpayer as an integral part of an activity specified in clause (i), or does not constitute research or storage facilities within the meaning of clause (ii), such property in certain circumstances may, nevertheless, be section 1245 property under subparagraph (B). An illustration of such a circumstance is when the adjusted basis of such property in the hands of the taxpayer reflects adjustments for depreciation with respect to such property taken for periods after December 31, 1961, at a time when such property was used as an integral part of manufacturing by the taxpayer or another taxpayer. Another illustration is when the adjusted basis of such property in the hands of the taxpayer reflects adjustments for depreciation with respect to *other* property (as, for example, in the case of a like kind exchange under sec. 1031) taken for periods after December 31, 1961, at a time when such other property was used as an integral part of manufacturing by the taxpayer.

(b) *Exceptions and limitations.*—Subsection (b) of section 1245 sets forth certain exceptions and limitations to the general rule provided in subsection (a). Paragraph (1) provides that subsection (a) will not apply to a disposition by gift. Paragraph (2) provides that, except as provided in section 691, subsection (a) will not apply to a transfer at death.

Paragraph (3) of section 1245(b) provides that 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 certain sections of the code providing for nonrecognition treatment, then the amount of gain taken into account by the transferor under subsection (a)(1) is to be limited to the amount of gain recognized by the transferor under these sections (determined without regard to sec. 1245). These nonrecognition provisions are: Section 332 (relating to distributions in liquidation of an 80 percent or more controlled subsidiary corporation); section 351 (relating to transfers to a corporation controlled by the transferor); section 361 (relating to exchanges pursuant to certain corporate reorganizations); section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings); section 374(a) (relating to exchanges pursuant to certain railroad reorganizations); section 721 (relating to transfers to a partnership in exchange for a partnership interest); and section 731 (relating to distributions by a partnership to a partner). For example, assume that a taxpayer transfers section 1245 property to a corporation in exchange for cash of $1,000, and stock in the corporation worth $9,000, in a transaction qualifying under section 351. The property has a fair market value of $10,000, a recomputed basis of $8,000, and an adjusted basis of $4,000. Since under section 351(b) gain in the amount of $1,000 would be recognized to the transferor without regard to the new section 1245, subsection (b)(3) limits the gain taken into account by the transferor under section 1245(a) to $1,000. The basis of the property in the hands of the corporation under section 362(a) (relating to basis to corporations of property acquired by issuance of stock, etc.) will be $5,000, that is, the adjusted basis of the property in the hands of the transferor ($4,000) increased by the gain recognized to the transferor on the transfer ($1,000). If the corporation later sells the property for $10,000 without having taken any deductions with respect to the property, the gain recognized to the corporation under subsection (a) will be $3,000, the excess of recomputed basis ($8,000) over adjusted basis ($5,000).

Since the limitation provided in subsection (b)(3) upon the gain recognized under subsection (a) is confined to instances of "carryover basis," in the case of the liquidation of an 80 percent or more controlled subsidiary the limitation is not applicable if the basis of the property in the hands of the parent corporation is determined under section 334(b)(2). Subsection (b)(3) does not apply to a disposition of property to an organization (other than a cooperative described in sec. 521) exempt from taxation under chapter 1 of the code, but no implication is intended as to whether a transfer to such an exempt organization could or could not qualify for nonrecognition under the sections of the code set forth in subsection (b)(3).

Paragraph (4) of section 1245(b) provides that if property is disposed of and gain (determined without regard to sec. 1245) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or 1033 (relating to involuntary conversions), then the amount of gain taken into account under section 1245(a) is not to exceed the sum of the amount of gain recognized on such disposition (determined without regard to sec. 1245) plus the fair market value of property acquired which is not section 1245 property and which is not otherwise taken into account in determining the gain under section 1031 or 1033. For example, assume that a taxpayer owns section1245 property with an adjusted basis of $100,000 and a recomputed basis of

$116,000. The property is destroyed by fire and the taxpayer receives $117,000 of insurance proceeds. He uses $105,000 of the proceeds to purchase property similar or related in service or use to the property destroyed in an acquisition qualifying under section 1033(a)(3)(A), and he uses $9,000 of the proceeds to purchase stock in the acquisition of control of a corporation owning property similar or related in service or use to the converted property, which acquisition also qualifies under section 1033(a)(3)(A). The taxpayer properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to the amount by which the amount realized from the conversion exceeds the cost of the stock and other property acquired to replace the converted property. Since $3,000 of the gain is recognized (without regard to sec. 1245) under section 1033(a)(3) (that is, $117,000 minus $114,000), and since the stock purchased for $9,000 is not depreciable property and was not taken into account in determining the gain under section 1033, the amount of gain to be taken into account under section 1245(a) may not exceed $12,000. Thus, section 1245(a) applies to $12,000 of the $16,000 gain.

Paragraph (5) of section 1245(b) empowers the Secretary of the Treasury or his delegate to prescribe regulations setting forth rules consistent with paragraphs (3) and (4) 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 nonrecognition of gain or loss on exchanges or distributions in obedience to orders of SEC).

Paragraph (6)(A) provides that, for purposes of section 1245, the basis of section 1245 property distributed by a partnership to a partner will be deemed to be determined by reference to the adjusted basis of such property to the partnership. Paragraph (6)(B) provides that, for purposes of computing the recomputed basis of such property, the amount of the adjustments added back for periods before the distribution is the amount of gain to which section 1245(a) would have applied if such property had been sold by the partnership immediately before the distribution, reduced by the amount of such gain which resulted from the application of section 751(b). Thus, since the basis of section 1245 property distributed by a partnership to a partner is deemed to be a carryover basis, any subsequent disposition of the property which requires a computation of the recomputed basis would have to take into account adjustments to basis for depreciation deductions taken before the distribution. However, such adjustments are fixed at an amount equal to the gain to which section 1245(a) would have applied if the partnership had sold the property instead of distributing it, assuming no gain upon distribution arose out of the application of section 751(b).

The application of this provision is illustrated as follows: A, B, and C are equal partners in a partnership whose assets consist of three pieces of section 1245 property, assets X, Y, and Z, each with a fair market value of $100,000. Asset X has an adjusted basis of $60,000 and a recomputed basis of $85,000; asset Y has an adjusted basis of $85,000 and a recomputed basis of $110,000; and asset Z has an adjusted basis of $95,000 and a recomputed basis of $100,000. Asset Y is distributed to B in complete liquidation of his partnership interest. B's basis in his partnership interest is $75,000, and under section 732 this basis is allocated to asset Y. If B later sells asset Y for $103,000 at a time when the adjusted basis is still $75,000 and if B has not taken any depreciation deductions with respect to asset Y since the distribution, the gain to which section 1245(a) applies would be $15,000, since the recomputed basis of the property is only $90,000, that is, the adjusted basis of the property ($75,000) increased by the amount of gain ($15,000) which would have been recognized to the partnership if the asset had been sold for its fair market value at the time of distribution ($100,000 minus $85,000).

(c) *Adjustments to basis.*—Subsection (c) of section 1245 provides that the Secretary of the Treasury or his delegate is to prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain to which section 1245(a) applies. This provision is necessary to prevent the same amount from being subjected to taxation more than once. For example, under existing law if a corporation distributes section 1245 property to a corporate shareholder, generally the amount of the distribution and the basis of the property in the hands of the corporate distributee is the fair market value of the property or its adjusted basis in the hands of the distributing corporation, whichever is lower. Under section 1245, however, the distribution may result in gain being recognized to the distributing corporation and unless the distributee is permitted to increase its carryover basis by the amount of the gain recognized to the distributor, the same gain may be subjected to tax when the distributee later sells the property. Therefore, under regulations prescribed by the Secretary of the Treasury or his delegate, adjustment will be made to the basis of the distributed property to reflect the gain recognized to the distributing corporation.

(d) *Application of section.*—Subsection (d) of section 1245 provides that the section is to apply notwithstanding any other provision of subtitle A of the code. Thus, section 1245 overrides any nonrecognition provision of subtitle A or any "income characterizing" provision. For example, the gain to which section 1245(a) applies might otherwise be considered as gain from the sale or exchange of a capital asset under section 1231 (relating to property used in the trade or business and involuntary conversions). Since section 1245 overrides section 1231, the gain to which section 1245(a) applies will be treated as ordinary income, and only the remaining gain, if any, from the property may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. For example, assume that a taxpayer sells for $130 section 1245 property with an adjusted basis of $40 and a recomputed basis of $100. The excess of the recomputed basis over adjusted basis, or $60, will be treated as gain under section 1245(a). The excess of the selling price over recomputed basis, or $30, may be considered under section 1231 as gain from the sale of a capital asset.

Subsection (d) is not intended to prevent gain not recognized under section 1245 from being considered as gain under another provision of the code. For example, assume that a taxpayer purchases section 1245 property for $1,000 and for periods before December 31, 1961, he takes deductions of $500 under section 168 (relating to amortization of emergency facilities). Assume that if section 168 had not applied the taxpayer would instead have taken depreciation deductions of $300. For periods after December 31, 1961, the taxpayer takes additional deductions under section 168 of $400. Under these facts, if the property is then sold for $800, section 1245(a) would recognize gain to the extent of the $400 in deductions taken in periods after

December 31, 1961, but would not recognize gain to the extent of the deductions taken in prior periods. Nothing in subsection (d) prevents $200 of the remaining gain from being taxed under section 1238 (relating to amortization in excess of depreciation).

SECTION 13. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY (Continued)

(b) *Change in method of depreciation.*—Subsection (b) of section 13 of the bill amends subsection (e) of section 167 of the 1954 Code (relating to depreciation). Paragraph (1) of section 167(e) is the same in substance as existing section 167(e). Under paragraph (2), which is new, the bill as passed by the House provided that any taxpayer may, within such period after the date of the enactment of the Revenue Act of 1962 and in such manner as the Secretary of the Treasury or his delegate shall by regulations prescribe, elect to change his method of depreciation in respect of section 1245 property from any declining balance or sum of the years-digits method to the straight-line method. Your committee's amendment provides that the taxpayer may make the election with respect to taxable years beginning after December 31, 1962, on or before the last day prescribed by law (including extensions thereof) for filing his return for such first taxable year.

(c) *Salvage value of personal property.*—Subsection (c)(1) of section 13 of the bill adds a new subsection (f) to section 167 of the code (relating to depreciation) and redesignates subsections (f), (g), and (h) of section 167 as subsections (g), (h), and (i), respectively.

Paragraph (1) of section 167(f) provides the general rule that, under regulations prescribed by the Secretary of the Treasury or his delegate, a taxpayer may, for purposes of computing the allowance for depreciation 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 sec. 167(g) as of the time as of which such salvage value is required to be determined). For example, a taxpayer purchases depreciable personal property on January 1, 1963, for $10,000. The estimated useful life of the property is 10 years and the estimated salvage value if $500. The taxpayer uses the straight-line method of depreciation. Under present law the taxpayer would take depreciation deductions of $950 in each of the 10 years of the useful life of the property. However, under section 167(f) the taxpayer may reduce salvage value, for purposes of computing the allowable depreciation deduction, by 10 percent of $10,000. Since this amount, $1,000, is greater than the estimated salvage value, $500, the salvage value may be reduced to zero and the taxpayer may deduct $1,000 in each year of the useful life of the property. In the above case, if the taxpayer had taken into account salvage value of only $700 but the estimated salvage value had actually been $1,500, the Internal Revenue Service could not adjust the amount used by the taxpayer since the reduction of salvage value by 8 percent of basis would be within the privilege granted by the new section 167(f).

Paragraph (2) of section 167(f) defines "personal property" as 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.

(d) *Special rule for charitable contributions of section 1245 property.*—Subsection (d) of section 13 of the bill adds a new subsection (e) to section 170 of the code (relating to deductions for charitable contributions). Under the new subsection, the amount of a charitable contribution of section 1245 property will be reduced by the amount which would have been treated as gain to which section 1245(a) applied if the property had been sold at its fair market value instead of contributed to the charity. For example, a taxpayer owns depreciable property with an adjusted basis of $10,000, a recomputed basis of $14,000, and a fair market value of $17,000. If the property were sold for $17,000, gain of $4,000 under section 1245(a) would result. Assume that the taxpayer contributes the property to a qualifying charitable organization. Under the new section 170(e) the amount of the charitable contribution would be $13,000 ($17,000 minus $4,000).

(e) *Computation of taxable income for purposes of limitation on percentage depletion deduction.*—Subsection (e) of section 13 of the bill, which has no corresponding provision in the bill as passed by the House, inserts a new sentence after the second sentence in section 613(a), relating to the general rule for computing percentage depletion. The new sentence, which does not affect the computation of the gross income from the property under the first sentence of section 613(a), provides that the allowable deductions taken into account with respect to expenses of mining in computing taxable income from the property shall, for purposes of the 50-percent limitation contained in the second sentence of section 613(a), be decreased by the gain recognized under section 1245(a) which is properly allocable to the property.

(f) *Technical amendments.*—This subsection of the bill is identical to subsection (e) of the bill as passed by the House. Paragraph (1) of section 13(f) of the bill amends section 751(c) of the code to provide that, for purposes of section 751 (relating to unrealized receivables and inventory items), section 731 (relating to extent of gain or loss on distribution), section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest), and section 741 (relating to recognition and character of gain or loss on sale or exchange), the term "unrealized receivables" will include section 1245 property, but only to the extent of the amount which would be treated as gain to which section 1245(a) applied if the property were sold by the partnership at its fair market value. Thus, the rules provided in section 751 with respect to unrealized receivables will also apply with respect to section 1245 property, to the extent of the potential section 1245(a) gain. For example, if a partner sold his interest in a partnership to a third party, the portion of the amount realized on such sale allocable to the partner's share of the potential section 1245(a) gain on the section 1245 property of the partnership will be recognized to the partner.

Paragraph (2) of section 13(f) of the bill amends section 301 (b) and (d) of the code (relating to the amount distributed and basis in a corporate distribution of property) 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)."

Paragraph (3) of section 13(f) of the bill amends section 312(c)(3) (relating to adjustments to earnings and profits) 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)."

Paragraph (4) of section 13(f) of the bill adds a new paragraph (12) to section 341(e) (relating to collapsible corporations). New paragraph (12) provides that, for purposes of section 341(e), the determination of whether gain from the sale or exchange of property would be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) is to be made without regard to the application of section 1245(a).

Paragraph (5)(A) of section 13(f) of the bill adds a new sentence at the end of section 453(d)(4)(A), relating to distribution of installment obligations in complete liquidations of subsidiaries under section 332. Section 453(d)(4)(A) provides that if an installment obligation is distributed by one corporation to another corporation and if under section 332 no gain or loss is recognized to the recipient corporation with respect to the receipt of such obligation, then no gain or loss with respect to the distribution of such obligation is recognized to the distributing corporation. The new sentence provides that if section 334(b)(2) (relating to the basis of property received in certain liquidations to which sec. 332 applies) applies in respect of property received by the distributee corporation, then the rule of existing law is not to apply to the extent that under paragraph (1) of section 453(d) gain to the distributing corporation would be considered as gain to which section 1245(a) applies. For example, assume that corporation X sells section 1245 property and returns its income therefrom on the installment method under section 453. Corporation Y then buys all the outstanding stock of X and within 2 years after the purchase X adopts a plan of complete liquidation. If an installment obligation received by X upon the sale of the section 1245 property is distributed to Y in the liquidation, gain will be recognized to X under paragraph (1) of section 453(d) to the extent that the excess of the fair market value of the obligation over its basis constitutes gain to which section 1245(a) applies.

Paragraph (5)(B) of section 13(f) of the bill adds a new sentence at the end of section 453(d)(4)(B), relating to distribution of installment obligations in liquidations to which section 337 applies. Section 453(d)(4)(B) provides that if an installment obligation is distributed by a corporation in the course of a liquidation and if under section 337 no gain or loss would have been recognized to the corporation if the corporation had sold or exchanged such obligation on the day of the distribution, then no gain or loss is recognized to the corporation by reason of the distribution. The new sentence provides that the preceding rule is not to apply to the extent that under paragraph (1) of section 453(d) gain to the distributing corporation would be considered as gain to which section 1245(a) applies. For example, assume that corporation X, which makes its return on the basis of the fiscal year ending June 30, adopts a plan of complete liquidation on March 15. On June 15, X sells section 1245 property and returns its income therefrom on the installment method under section 453. On October 15, X distributes all of its property (including an installment obligation received in respect of the sale) in complete liquidation. Gain will be recognized to X under paragraph (1) of section 453(d) to the extent that the excess of the fair market value of the installment obligation over its basis constitutes gain to which section 1245(a) applies.

(g) *Effective dates.*—Subsection (g) corresponds to subsection (f) of the bill as passed by the House which provided that the amendments made by this section of the bill shall apply to taxable years beginning after December 31, 1961, and ending after the date of the enactment of the bill. Your committee's amendment provides that the amendments made by this section shall apply to taxable years beginning after December 31, 1962, except that subsection (c) of this section shall apply to taxable years beginning after December 31, 1961, and ending after the date of enactment of the bill.

SECTION 14. FOREIGN INVESTMENT COMPANIES

(a) *Treatment of sale of stock of foreign investment companies.*—Section 14(a) of the bill adds to the code a new section 1246 (relating to gain on foreign investment company stock) and a new section 1247 (relating to election by foreign investment companies to distribute income currently). Section 1246 provides for the inclusion as ordinary income of certain gains from the sale or exchange of stock in a foreign investment company. However, section 1246 will not apply to the qualified shareholders of a registered foreign investment company which elects, under section 1247, to distribute its income currently.

This section is substantially similar to section 15 of the bill as passed by the House. However, your committee has made certain clarifying changes and has added a provision permitting a foreign investment company which elects to distribute its income currently to make a further election, if more than 50 percent of the value of its assets consists of stock or securities in foreign corporations, to allow its shareholders to treat as paid by them their proportionate shares of the foreign taxes paid by the investment company. Your committee has also added a provision allowing registered foreign investment companies the opportunity to reincorporate tax free in the United States without obtaining a ruling from the Commissioner under section 367.

SECTION 1246. GAIN ON FOREIGN INVESTMENT COMPANY STOCK

(a) *Treatment of gain as ordinary income.*—Under subsection (a)(1) of section 1246, the bill as passed by the House provided that any gain from the sale or exchange after December 31, 1962, of stock to which the subsection applies is to be treated as gain from the sale or exchange of property which is not a capital asset, but only to the extent of the taxpayer's ratable share of the earnings and profits of the company accumulated for taxable years beginning after December 31, 1962. Your committee has amended this provision to make it clear that any gain upon a distribution which, under section 302 or 331, is treated as a sale or exchange of stock shall be given the same treatment. Any additional gain or any loss on the sale or exchange of such stock will remain unaffected by these provisions. Subsection (a)(1) applies to stock in a foreign corporation which was a foreign investment company at any time during the period during which the taxpayer held such stock. Thus subsection (a)(1) applies whether or not the foreign corporation is within the definition of a foreign investment company at the time of the sale or exchange. However, since under section 14(c) of the bill, section 1246 applies only with respect to taxable years beginning after December 31, 1962, the corporation must have been a foreign investment company while the taxpayer held the stock at some time during such a taxable year.

Subsection (a)(2) of the new section 1246 provides that the taxpayer's ratable share of the accumulated earnings and profits is to be determined under regulations prescribed by the Secretary of the Treasury or his delegate. Such determination is to include only the taxpayer's ratable share of the earnings and profits of the foreign corporation accumulated for the period during which the taxpayer held stock in such foreign corporation (excluding any portion of such period occurring in a taxable year of the corporation beginning before January 1, 1963). The bill provides that such determination will exclude the taxpayer's share of undistributed earnings and profits which previously had been taxed to him under section 951 (relating to amounts included in gross income of U.S. persons, added by sec. 12 of the bill) or under section 551 (relating to foreign personal holding company income taxed to U.S. shareholders). Under the bill as amended by your committee only such earnings and profits attributable to any amount previously included in the gross income of such taxpayer under section 951 will be excluded, and then only to the extent that such inclusion under section 951 did not result in an exclusion of any other amount from gross income under section 959. The amount of the accumulated earnings and profits for any period is determined after applying the rules of the code that distributions are treated as made out of the most recently accumulated earnings and profits.

Subsection (a)(3) of the new section 1246 requires the taxpayer to establish the amount of the accumulated earnings and profits of the foreign corporation and his ratable share of such amount. He must establish this information for the period during which he held such stock, including whatever holding period is required by other subsections of section 1246. Failure to establish this information will result in all the gain from the sale or exchange of such stock being considered as gain from the sale or exchange of property which is not a capital asset.

Subsection (a)(4) of the new section 1246 provides that section 1246 is not to apply where the holding period of the stock as of the date of the sale or exchange is 6 months or less.

(b) *Definition of foreign investment company.*—The definition of foreign investment company in subsection (b) of section 1246 has been amended by your committee. The House bill defined a foreign investment company as any foreign corporation which satisfied one of two alternative tests. Your committee bill provides that either of these two tests must be satisfied for any taxable year beginning after December 31, 1962, in order for a foreign corporation to be a foreign investment company. The first test is met if the foreign corporation is 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. Under the Investment Company Act of 1940, an investment company organized or created under the laws of a foreign country is required to register with the Securities and Exchange Commission in order to make a public offering of its securities in the United States. The act defines an investment company, in general, as any issuer of securities which is or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities. Under the second test provided by the new section 1246(b), a foreign corporation, even though it does not make a public offering of its securities and does not register under the act, is a foreign investment company if it satisfies two conditions. The first condition under the House bill was that the foreign corporation must be engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (within the meaning of sec. 3(a)(1) of the act). The bill as amended by your committee provides that section 3(a)(1) of the act would be limited by paragraphs (2) through (10) (except par. (6)(C)) and paragraphs (12) through (15) of section 3(c) of such act for purposes of determining if the first condition is satisfied. The effect of your committee's amendment is to exclude from foreign investment company treatment certain foreign corporations such as, for example, brokers, banks, and small loan companies. Under the second condition, the first condition must be satisfied at a time when 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, was held directly or indirectly (within the meaning of sec. 958(a) of the code, added by sec. 12 of the bill), by U.S. persons (as defined in sec. 7701(a)(30) of the code, added by sec. 7(h) of the bill). Under the Investment Company Act of 1940, the term "security" is defined broadly and includes among others, stock, treasury stock, bond, debenture, any evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, certificate of deposit for a security, or a fractional undivided interest in oil, gas, or other mineral rights.

(c) *Stock having transferred or substituted basis.*—Subsection (c) of new section 1246 provides that 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 such taxpayer's hands or any other person's hands) of stock in a foreign investment company, will to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate be treated as stock of a foreign investment company. The stock which is so treated will be considered under section 1223 (relating to holding period of property) to be held by the taxpayer throughout the period during which the foreign investment company stock was held in addition to the period during which the stock in the foreign corporation is held. Transactions to which subsection (c) applies include the following:

A person owning stock in a foreign investment company transfers such stock to foreign corporation F which he controls in exchange for stock of corporation F in a transaction to which section 351 applies. Clearance under section 367 is obtained. The stock of corporation F received in exchange for the foreign investment company stock will be considered stock of a foreign investment company. If the stock of corporation F is later transferred by gift, the donee will also treat such stock as stock of the foreign investment company and the holding period of the donee will include the period during which the donor held the stock in the foreign investment company and corporation F.

(d) *Rules relating to entities holding foreign investment stock.*—Subsection (d) of the new section 1246 provides that to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, trust certificates of a trust to which section 677 (relating to income for benefit of grantor) applies, and stock in a domestic corporation, will be treated as stock of a foreign investment company to the extent that such trust or corporation has an investment in stock in a foreign investment company. As a result of this provision the taxpayer is deemed to be holding stock of the foreign investment company. The trust certificates or stock are to be treated under section 1223 as held by the taxpayer throughout the holding period for which the trust or domestic corporation held stock in a foreign investment company, but limited to the period during which the taxpayer held such trust certificates or stock in the domestic corporation. Such stock is deemed to be held by him in the same proportion that the actual investment in stock in a foreign investment company by the trust or domestic corporation bears to the total assets of such trust or domestic corporation. For example, if a domestic corporation has an investment of $20,000 in stock of a foreign investment company and total assets of $100,000, the proportion of the domestic corporation's investment is 20 percent. Therefore, 20 percent of each share of stock in such corporation will be deemed to be foreign investment stock and 20 percent of the gain, if any, resulting from the sale or exchange thereof, will be subjected to section 1246 treatment.

(e) *Rules relating to stock acquired from a decedent.*—Paragraph (1) of subsection (e) sets forth the manner for computing the basis of stock in a foreign investment company which is acquired from a decedent dying after December 31, 1962, and treats the holding period by the heir or successor in the manner provided for in subsection (e). Under paragraph (1) of subsection (e) the stock's basis determined under section 1014 will be reduced by the decedent's ratable share of the company's earnings and profits accumulated in taxable years beginning after December 31, 1962. For example, if the stock had an adjusted basis of $100, a fair market value of $150 on the date of the decedent's death, and $30 was the decedent's ratable share of the accumulated earnings and profits during the period he held such stock after December 31, 1962, the person acquiring the stock from the decedent would have a basis of $120 ($150—$30). In no case is the basis determined under section 1014 to be reduced below the adjusted basis of the stock in the hands of the decedent immediately before his death, regardless of the decedent's ratable share of such earnings. Thus, in the above example, the basis could not be reduced below $100.

The stock so acquired from a decedent shall be treated as if it were held throughout the holding period of the decedent in addition to the holding period of the person acquiring the stock. Thus, in effect, the holding period of the decedent is tacked onto that of the person acquiring the stock. If, in the example illustrated in the preceding paragraph, the stock were sold immediately after acquisition at its fair market value of $150, the gain of $30 ($150—$120) would be treated as gain from the sale of property which is not a capital asset. If, after acquisition the stock further increased in value, upon a sale or exchange, $30 plus the portion of the gain which is equal to the taxpayer's ratable share of the accumulated earnings and profits of the corporation for the period during which he held such stock would be treated in the same manner.

In the event the decedent's executor decides to determine the gross estate under section 2032 (relating to alternate valuation), for purposes of section 1246(e), the date the stock is so valued will be considered the date of the decedent's death. Therefore, the basis determined at such later date will be reduced by the decedent's ratable share of the earnings and profits accumulated during the period preceding the date of his death and the earnings and profits accumulated during the period between such date and the date of alternate valuation.

Paragraph (2) of section 1246(e) provides that if foreign investment company stock acquired from a decedent is sold or exchanged at a gain which gain is subject to ordinary income treatment under subsection (a) of section 1246, the taxpayer, under regulations prescribed by the Secretary of the Treasury or his delegate, is to be allowed a deduction from gross income, for the taxable year of the sale or exchange, 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 representing the reduction in basis described in paragraph (1). The value determined in (B) is actually the taxpayer's basis of the stock as determined under section 1246(e)(1). The provision of paragraph (1) may be illustrated by the following example:

Example

The gross estate of a decedent dying in 1963 was $125,000, which included foreign investment company stock valued at $5,000. Assuming deductions of $10,000 and an exemption of $60,000, the taxable estate amounted to $55,000. The estate tax paid on this amount is $8,250. Assuming that the decedent's share of earnings and profits accumulated after December 31, 1962, was $500 the heir's basis for such stock determined under section 1246(e)(1) would be $4,500. If the heir sold such stock in 1963, he is allowed to deduct the following amount from his 1963 gross income:

Estate tax actually paid (on taxable estate of $55,000)	$8, 250
Less: Estate tax computed by reducing the gross estate by $500 (tax on taxable estate of $54,500)	8, 125
Amount deducted from the heir's gross income	125

If in 1963, the heir had sold only one-half of the stock, then only $62.50 (one-half of $125) could have been deducted from his gross income.

(f) *Information with respect to certain foreign investment companies.*—Subsection (f) of section 1246 requires certain U.S. shareholders of a foreign investment company to furnish with respect to such company such information as the Secretary of the Treasury or his delegate shall by regulations prescribe. The requirement is applicable only to those U.S. persons who on the last day of the taxable year of a foreign investment company beginning after December 31, 1962, own 5 percent or more in value of the stock of such company.

(g) *Nonapplication of section 367 in certain cases.*—Your committee has redesignated subsection (g) of section 1246 in the bill as passed by the House as subsection (h) and has added a new subsection (g) which has no corresponding provision in the bill as passed by the House. The new subsection (g) provides that if a registered foreign investment company described in subsection (b)(1) has made an effective election to distribute income currently under section 1247 with respect to taxable years beginning after December 31, 1962, then section 367 will not apply in respect of such foreign investment company if the company is a party to a reorganization (within the meaning of sec. 368) in which all of its properties are acquired before January 1, 1964, by a domestic corporation which is a regulated investment company under section 851 for its first taxable year ending after the reorganization.

(h) *Cross-reference.*—Subsection (h) of section 1246, which corresponds to subsection (g) in the bill as passed by the House, is a cross-reference to section 312(l) of the code (relating to effect on earnings and profits of foreign investment companies) which is added by section 14(b)(1) of the bill.

SECTION 1247. ELECTION BY FOREIGN INVESTMENT COMPANIES TO DISTRIBUTE INCOME CURRENTLY

Section 1247, which is added to the code by section 14(a) of the bill, provides that section 1246 will not apply to the shareholders of a registered foreign investment company if such company makes the election provided for by section 1247, and if the shareholders include in their income their pro rata share of the excess of the net long-term capital gain over the net short-term capital loss of the company for each taxable year.

(a) *Election by foreign investment company.*—Section 1247(a)(1) provides that if a foreign investment company of the type defined in section 1246(b)(1) (relating to registered foreign investment companies) makes the election provided by section 1247, section 1246 will not apply with respect to its qualified shareholders during any taxable year of the company to which the election is effective. Such election must be made on or before December 31, 1962, in the manner provided in regulations prescribed by the Secretary of the Treasury or his delegate. The election commits the company to fulfill the requirements provided in subparagraphs (A), (B), and (C) of subsection (a)(1) for each taxable year beginning after December 31, 1962.

Under subparagraph (A), the company elects to distribute to its shareholders during each taxable year at least 90 percent of its taxable income for such year. For this purpose, taxable income is the amount determined as if such company were a domestic corporation but with the adjustments provided in subparagraph (A) of paragraph (2).

Under subparagraph (B), the bill provided that the company elects to designate, in a written notice mailed to its shareholders at any time before 30 days after the close of its taxable year, the pro rata amount of the excess of the net long-term capital gain over the net short-term capital loss and the portion thereof which is being distributed. The bill as amended by your committee provides that the written notice shall be mailed at any time before 45 days after the close of such taxable year. Such determinations are to be made as if such company were a domestic corporation.

Under subparagraph (C), the company elects to provide such information as the Secretary of the Treasury or his delegate deems necessary to carry out the purposes of section 1247.

Paragraph (2)(A) of subsection (a) provides special rules for computing taxable income under paragraph (1)(A).

Subparagraph (A) states that such taxable income will be determined without regard to—

(i) the excess of the net long-term capital gain over net short-term capital loss for the taxable year,

(ii) the net operating loss deduction under section 172, and

(iii) the deductions provided in part VIII of subchapter B (relating to special deductions for corporations), other than the deduction provided in section 248 (relating to organizational expenses).

Paragraph (2)(B) provides that in determining the amount of the distribution made under paragraph (1)(A), a distribution made after the close of the taxable year but on or before the 15th day of the third month of the next taxable year will be treated by the company (but not by its shareholders) as distributed during the earlier year to the extent elected by the company on or before the 15th day of such third month. Such election is to be made in accordance with regulations prescribed by the Secretary of the Treasury or his delegate.

Subparagraph (C) of paragraph (2) provides that for purposes of making the computations under paragraph (1)(B), any capital loss under section 1212 incurred prior to the first effective year of the election will not be carried forward to the period for which the election is effective.

(b) *Years to which election applies.*—Subsection (b) of the new section 1247 provides that the election is to terminate starting with the first day of the first taxable year in which—

(1) the company fails (unless it is shown that such failure is due to reasonable cause and not due to willful neglect) at any time to comply with any of the requirements set forth in subsection (a)(1),

(2) the company is a foreign personal holding company, or

(3) the company is not a registered foreign investment company as described in section 1246(b)(1).

It is recognized that some registered foreign investment companies may experience difficulties in ascertaining the extent to which distributions which they receive on investments in stocks of other foreign corporations represent income to them under the standards of the Internal Revenue Code; for example, this may be true with respect to distributions from foreign mining companies. The bill provides in section 1247(b)(1) that the company will not be disqualified under section 1247 if its failure to distribute 90 percent of its income is due to reasonable cause and not due to willful neglect. If in determining its income, the company relies in good faith upon estimates and opinions of independent certified public accountants or other experts which are also used for purposes of its financial statements filed with the Securities and Exchange Commission under the Investment Company Act of 1940, such reliance would constitute reasonable cause for this purpose.

(c) *Qualified shareholders.*—Paragraph (1) of subsection (c) of section 1247 defines a "qualified shareholder" to mean a shareholder who is a U.S. person (as defined in sec. 7701(a)(30), added by sec. 7(h) of the bill) other than a shareholder described in paragraph (2).

Paragraph (2) provides that a U.S. person is not to be treated as a qualified shareholder for his taxable year if for such taxable year (or for any prior taxable year) he fails to include (in computing his long-term capital gains in his return for such taxable year) the amount designated by the company as his pro rata share of the undistributed portion of the excess of the net long-term capital gain over the net short-term capital loss of the company for the company's taxable year ending within or with the shareholder's taxable year. Once a taxpayer fails to comply with the provisions of this paragraph in determining his status as a qualified shareholder, he loses the benefits of a qualified shareholder for the duration of the election and section 1246 will apply when he sells or exchanges the stock of the foreign investment company at a gain. However, if a taxpayer can show that the failure to include his share of the undistributed capital gains in his return was due to reasonable cause and not due to willful neglect, he will continue to be treated as a qualified shareholder.

(d) *Treatment of distributed and undistributed capital gains by qualified shareholders.*—Your committee has redesignated subsection (d) (relating to adjustments) of the new section 1247 as subsection (e) and has substituted a new subsection (d) which has no corresponding provision in the bill as passed by the House. The new subsection (d) provides rules for the treatment at the shareholder level of the distributed and undistributed portions of certain capital gains of a foreign investment company. Such capital gains are the excess of the net long-term capital gain over the net short-term capital loss for each taxable year of a foreign investment company with respect to which an election pursuant to subsection (a) is in effect. These rules for the treatment of such gains apply only to shareholders of such company who are qualified shareholders within the meaning of subsection (c).

Paragraph (1) of subsection (d) provides that every qualified shareholder of such company shall include his pro rata share of the distributed portion of such capital gains of such company in computing his long-term capital gains for his taxable year in which such distributed portion is received. Rules of existing law will continue to apply with respect to the receipt of such amounts by shareholders who are not qualified shareholders within the meaning of subsection (c). Accordingly, an unqualified shareholder would treat his pro rata share of the distributed portion of such capital gains as dividend income taxable at ordinary income rates.

Paragraph (2) of subsection (d) provides that every qualified shareholder of such company, in computing his long-term capital gains for his taxable year in which or with which the taxable year of the company ends, shall include his pro rata share of the undistributed portion of such capital gains for the taxable year of the company.

(e) *Adjustments.*—Subsection (e) of the new section 1247, which corresponds to subsection (d) in the bill as passed by the House, provides that proper adjustment, under regulations prescribed by the Secretary of the Treasury or his delegate, shall be made to reflect the inclusion in gross income of a qualified shareholder of his pro rata share of the undistributed portion of such capital gains under subsection (d)(2).

Under paragraph (1), the bill as passed by the House provided that such adjustment shall be made to the earnings and profits of the electing foreign investment company. The bill as reported provides in addition that such adjustment shall be made to a qualified shareholder's ratable share of such earnings and profits.

Paragraph (2), provides that adjustment shall also be made to the adjusted basis of stock held by qualified shareholders of the company.

(f) *Election by foreign investment company with respect to foreign tax credit.*—Subsection (f) of the new section 1247, for which there is no corresponding provision in the bill as passed by the House, provides that certain foreign investment companies may elect to be treated as conduits for the purposes of income, war profits, and excess profits taxes described in section 901(b)(1) which such companies pay to foreign countries and possessions of the United States. If such an election is made, the qualified shareholders may apply their proportionate shares of such foreign taxes either as a credit under section 901 or as a deduction under section 164(a) to the same extent as if they had paid such foreign taxes. The election may be made by a foreign investment company for any taxable year with respect to which an election pursuant to subsection (a) is in effect, if more than 50 percent of the value of the company's total assets at the close of such taxable year consists of stock or securities in foreign corporations. The conduit treatment provided in this subsection is not available with respect to taxes deemed to have been paid under section 902 (relating to the credit allowed to corporate shareholders of a foreign corporation for taxes paid by such foreign corporation).

If a foreign investment company for a taxable year elects the conduit treatment for foreign taxes under subsection (f), the determination of whether the election under subsection (a) is in effect for such taxable year is made in accordance with the rules provided in paragraph (1) of subsection (f). Under these rules, taxable income of the foreign investment company is computed without any deductions for income, war profits, or excess profits taxes (which are described in sec. 901(b)(1)) paid to foreign countries or possessions of the United States and the amount of such taxes are treated as distributed to shareholders for purposes of satisfying the requirement in subsection (a)(1)(A) that at least 90 percent of taxable income be distributed.

Under paragraph (2) of subsection (f), each qualified shareholder of the foreign investment company making the election under this subsection is required to include in his gross income and treat as paid by him his proportionate share of foreign taxes described in subsection (f)(1)(A), which were paid by the foreign investment company. For purposes of applying the foreign tax credit, the qualified shareholder shall treat his proportionate share of such taxes as having been paid to the country in which the foreign investment company is incorporated.

(g) *Notice to shareholders.*—Subsection (g) of section 1247, for which there is no corresponding provision in the bill as passed by the House, provides that the amounts to be treated by a qualified shareholder, for purposes of subsection (f)(2), as his proportionate share of taxes described in subsection (f)(1)(A) paid by the foreign investment company shall not exceed the amounts designated by the foreign investment company in a written notice mailed to its shareholders not later than 45 days after the close of its taxable year.

(h) *Manner of making election and notifying shareholders.*—This subsection, which has no corresponding provision in the bill as passed by the House, provides that the election by the foreign investment company to make the foreign tax credit available to its shareholders under subsection (f) and the notice to its shareholders of the designation of certain amounts under subsection (g) shall be made in the manner provided in regulations to be prescribed by the Secretary of the Treasury or his delegate.

(i) *Loss on sale or exchange of certain stock held less than 6 months.*—Subsection (i) which is identical to subsection (e) of section 1247 of the bill as passed by the House, provides that if a share of stock is held by a qualified shareholder for less than 6 months and if he treats any amount designated under section 1247(a)(1)(B) as long-term capital gain with respect to such shares, then any loss on the sale or exchange of such share (to the extent of the amount so treated as long-term capital gain) shall be treated as loss from the sale or exchange of a capital asset held for more than 6 months. For example, on December 20, 1963, A purchases a share of stock in corporation F, an electing foreign investment company, for $50. Corporation F (which is on a calendar-year basis) designates A's share of its long-term capital gains for the year 1963 as being $5. No distribution with respect to capital gains is made. A, therefore, includes $5 in computing his long-term capital gains in his return for 1963. On January 10, 1964, A sells such share for $49. Since A has a basis of $55 (the $50 original cost plus the $5 capital gain included in income but not distributed) the sale results in a loss of $6. Subsection (e) treats $5 of this loss as a long-term capital loss.

SECTION 14. FOREIGN INVESTMENT COMPANIES (Continued)

(b) *Conforming amendments.*—Paragraph (1) of section 14(b) of the bill amends section 312 of the 1954 Code (relating to effect on earnings and profits) by adding after subsection (k) thereof a new subsection (l).

Paragraph (1) of subsection (l) provides that upon the sale or exchange of stock in a foreign investment company by a shareholder who is a U.S. person, if such foreign investment company is a member of an affiliated group (as defined in par. (2)), then the accumulated earnings and profits of all member companies are to be allocated under regulations prescribed by the Secretary of the Treasury or his delegate, in such a manner as to carry out the purposes of section 1246.

Paragraph (2) of subsection (l) defines the term "affiliated group" for purposes of subsection (l)(1) to have the same meaning as such term has in section 1504(a) except that (A) "more than 50 percent" is substituted for "80 percent or more" wherever appearing in section 1504(a), and (B) all corporations are treated as includible corporations without regard to section 1504(b).

Paragraph (3) of new subsection (l) provides a rule governing the reduction in the earnings and profits of a foreign investment company as a result of amounts distributed by a foreign investment company in a partial liquidation or in redemptions to which section 302(a) or 303 applies. The portion of the distribution which is chargeable to earnings and profits shall be an amount which is not in excess of the redeemed stock's ratable share of the earnings and profits of the company accumulated after February 28, 1913. The effect of this provision is to allocate to each share of stock (whether or not redeemed) an equal amount of the company's accumulated earnings and profits at the time of the redemption. Paragraph (3) of subsection (l) applies only to such distributions made after December 31, 1962. The application of subsection (l)(3) of section 312 may be illustrated by the following example: Corporation F, a foreign investment company, has accumulated earnings and profits of $10,000 on December 31, 1963, on which date corporation F redeems shareholder A's stock for cash in the amount of $4,000. A is a 20-percent shareholder. Under the amendment the earnings and profits of the corporation are reduced by only $2,000 (20 percent of $10,000).

Paragraph (2) of section 14(b) of the bill amends section 751(d)(2) of the code (relating to inventory items of a partnership which have appreciated substantially in value) by adding new subparagraphs (C) and (D) which provide treatment for the sale or exchange of an interest in a partnership which holds stock in a foreign investment company. The amendment treats foreign investment company stock as an inventory item of the partnership under subsection (d)(2) of section 751. If an interest in a partnership, holding stock in a foreign investment company, is sold or exchanged, and if section 1246(a) would apply to the gain on the sale or exchange of such stock were such stock sold or exchanged by the partnership, the amount received for such interest which is attributable to the inventory items under section 751(d)(2) (including foreign investment company stock) will be taxed at ordinary income rates, provided under section 751(d)(1) the substantial appreciation tests for inventory items of the partnership are satisfied.

Paragraph (3) of section 14(b) of the bill amends section 1223 of the code (relating to holding period of property) by redesignating paragraph (10) as paragraph (11) and adding a new paragraph (10). Paragraph (10) requires a taxpayer in determining the period for which he held certain trust certificates to which section 1246(d) applies (relating to entities holding foreign investment company stock), or the period for which he held stock to which such section applies, to include the period for which the trust or corporation held the stock of foreign investment companies.

(c) *Effective date.*—Subsection (c) of section 14 of the bill provides that the amendments made by section 14 are to apply with respect to taxable years beginning after December 31, 1962.

SECTION 15. 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.*—Subsection (a) of section 15 of the bill, corresponding to section 16 of the bill as passed by the House, amends part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) by adding after section 1247 (as added by sec. 14 of the bill) a new section 1248.

SECTION 1248. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

Section 1248 provides that gain recognized on the sale or exchange of stock by a U.S. person owning 10 percent or more of the voting stock of a foreign corporation shall be included in gross income of such person as a dividend to the extent of the earnings and profits of the foreign corporation attributable to the period the stock sold or exchanged was held by such person while the foreign corporation was a controlled foreign corporation. Section 1248 also provides a limitation on the amount of tax payable by a U.S. person who is an individual, as defined in section 7701(a)(30)(A) (added by sec. 7 of the bill), and special rules for determining earnings and profits of a foreign corporation for purposes of this section.

(a) *General rule.*—Subsection (a) of section 1248 provides two prerequisites to the application of the section. First, a U.S. person, as defined in section 7701(a)(30), must sell or exchange stock in a foreign corporation. For this purpose, distributions under section 302, relating to distributions in redemption of stock, or section 331, relating to complete or partial liquidations of a corporation, are treated as exchanges. Second, a U.S. person must have owned within the meaning of section 958 (added by sec. 12 of the bill), 10 percent or more of the total combined voting power of all class of stock entitled to vote of the foreign corporation at any time during the 5-year period ending on the date of sale or exchange, and the foreign corporation must have been a controlled foreign corporation, as defined in section 957 (added by sec. 12 of the bill), on such date. If these conditions are satisfied, section 1248(a) requires that if a gain is recognized by the U.S. person on the sale or exchange of the stock of the foreign corporation, such amount of the gain as does not exceed the U.S. person's proportionate share of the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary of the Treasury or his delegate) to the stock sold or exchanged which were (1) accumulated in taxable years of the foreign corporation beginning after December 31, 1962, (2) during the period or periods the stock sold or exchanged was held by such person, and (3) while such foreign corporation was a controlled foreign corporation, shall be included in gross income of the U.S. person as a dividend. Section 1248 will not apply to exchanges in which gain is not recognized, for example, exchanges described in sections 332, 351, 354, 355, or 361 of the code, if before such exchange, as prescribed in section 367, it has been established to the satisfaction of the Secretary of the Treasury or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

To the extent gain is included in gross income as a dividend, the pertinent rules of subpart A of part III of subchapter N, relating to foreign tax credits, apply. Thus, foreign-tax credits for amounts allowed under section 901(b) with respect to taxes paid, and section 902 with respect to taxes deemed to be paid, are allowable if the U.S. person chooses to have the benefits of such sections. That part of the gain in excess of the amount included in gross income as a dividend under section 1248 is treated as provided by the code without regard to new section 1248 and there is no foreign tax credit with respect to taxes paid by the foreign corporation as to the portion of the gain that is not a dividend.

The bill as passed by the House would have treated as a dividend gain attributable to earnings and profits of foreign corporations accumulated after February 28, 1913, and in taxable years of such corporations ending on or before December 31, 1962, or gain attributable to earnings and profits of foreign corporations for periods during which a U.S. person was a shareholder in a foreign corporation at a time when the foreign corporation was not a controlled foreign corporation. The bill as passed by the House contained no provision for the allowance of a foreign tax credit in the case of the sale or exchange, other than in redemption or liquidation, of stock in a controlled foreign corporation.

The application of this subsection may be illustrated by the following examples:

Example 1.—A, an individual U.S. person, is, and always has been, the sole shareholder of foreign corporation X. X was organized on January 1, 1961, and had earnings and profits of $100 in the taxable year ending December 31, 1961, $200 in taxable year 1962, and $50 in taxable year 1963. A sold all his stock, a capital asset, in corporation X on December 31, 1963, and realized a gain of $400. Fifty dollars of the total gain (A's share of the earnings and profits of X for taxable year 1963) is includible in gross income of A as a dividend and $350 is includible in gross income of A as gain from the sale or exchange of a capital asset held for more than 6 months.

Example 2.—Assume the same facts as in example 1, except that A sold one-half of his shares in corporation X on December 31, 1963, rather than his entire stock interest, and realized a gain of $150. Twenty-five dollars of the total gain is includible in gross income of A as a dividend and the remaining $125 of gain is includible in gross income of A as gain from the sale or exchange of a capital asset held for more than 6 months.

Example 3.—U.S. person A, a domestic corporation, on January 1, 1963, owned 35 shares of stock in corporation X, a foreign corporation which was not a less developed country corporation. The remaining shares of X stock were held by U.S. individual B, 10 shares, and foreign corporation M, 55 shares. On January 1, 1964, A purchased 10 shares of corporation X stock from M and on January 1, 1965, A purchased 10 shares of corporation X stock from B. Corporation X had earnings and profits of $100 in each of the years 1963, 1964, and 1965 after payment of foreign income tax of $25 in each such year (20-percent rate). A sold all its stock in corporation X, 55 shares, on December 31, 1965, and realized a total gain of $500. Of the total gain, $100 (45 percent of the earnings and profits of 1964 and 55 percent of the earnings and profits of 1965 (corporation X was not a controlled foreign corporation in 1963)) is includible in gross income of A as a dividend and $400 is includible in gross income of A as gain from the sale or exchange of a capital asset held for more than 6 months. A, being a domestic corporation and owning at least 10 percent of the voting stock of foreign corporation X, could choose the foreign tax credit benefits of the code. Therefore, since foreign corporation X had paid a foreign income tax of 25 percent on the amount includible in income as a dividend, the inclusion of an amount under section 1248 would result in a net additional Federal income tax of 32 percent (assuming an effective U.S. tax rate of 52 percent) of the grossed-up amount included in gross income, a tax result equivalent to that which would have followed a distribution of earnings and profits to A by the controlled foreign corporation. The amount of tax payable under this chapter would be computed as follows:

Amount includible in gross income as a dividend		$100.00
Amount included in gross income under sec. 78:		
1965: $25×55/100	$13.75	
1964: $25×45/100	11.25	
Total foreign tax paid with respect to $100		25.00
Total amount included in gross income		125.00
Tentative U.S. tax (at 52 percent rate)		65.00
Foreign tax credit (sec. 902)		25.00
Net U.S. tax		40.00

Example 4.—Assume the same facts as in example 3 except that A sold 30 shares of corporation X stock, rather than 55 shares, upon which A realized a total gain of $300. The shares sold represented 10 shares purchased from B on January 1, 1965, 10 shares purchased from corporation M on January 1, 1964, and 10 shares owned by A on January 1, 1963. Of the total gain, $50 (20 percent of the earnings and profits of 1964 ($20) and 30 percent of the earnings and profits of 1965 ($30)) is includible in gross income of A as a dividend, and $250 is includible as gain from the sale or exchange of a capital asset held for more than 6 months.

(b) *Limitation of tax applicable to individuals.*—Subsection (b) of section 1248, for which there is no corresponding provision in the bill as passed by the House, provides for a limitation of Federal income tax resulting from the inclusion in gross income of an individual U.S. person of an amount as a dividend under the provisions of section 1248(a).

Paragraph (1) of section 1248(b) provides that the tax attributable to an amount included in the gross income of a U.S. person in accordance with the provisions of section 1248(a) shall not be greater than an amount described in paragraph (2) or paragraph (3), whichever is lesser.

Paragraph (2) of section 1248(b) applies if the stock sold or exchanged, including distributions treated as exchanges under sections 302 or 331, is a capital asset, within the meaning of section 1221, and such stock has been held by the U.S. person for more than 6 months. If these conditions are met, the limitations of tax applicable to an amount includible in gross income of an individual U.S. person under section 1248(a) is an amount equal to the sum of the amounts determined under subparagraphs (A) and (B) of section 1248(b)(2), if such amount is less than the amount determined under paragraph (3) of section 1248(b).

Subparagraph (A) of section 1248(b)(2) provides for an amount equal to a pro rata share of the excess of an amount determined under the provisions of clause (i) over an amount determined under the provisions of clause (ii).

Clause (i) of section 1248(b)(2)(A) provides for an amount equal to the taxes that would have been paid by the foreign corporation had it been taxed under chapter 1 as a domestic corporation for the period or periods the stock sold or exchanged was held by the

U.S. person while the foreign corporation was a controlled foreign corporation in taxable years beginning after December 31, 1962. In determining the amount of Federal income tax the foreign corporation would have paid as a domestic corporation, the nature and amount of income of the foreign corporation will be determined under the provisions of the code as it relates to domestic corporations. Thus, gain on the sale of a capital asset held for more than 6 months is considered long-term capital gain, so much of taxable income as does not exceed $25,000 is exempt from surtax, etc. However, no deduction or credit will be allowable from gross income for income, war profits, or excess profits taxes paid by the foreign corporation. Income, deductions, credits, or allowances will be taken into account only for the period or periods the stock sold or exchanged was held by the U.S. person in taxable years beginning after December 31, 1962, while the foreign corporation was a controlled foreign corporation, adjusted for distributions and amounts previously included in gross income of a U.S. shareholder under section 951.

Clause (ii) of section 1248(b)(2)(A) provides for an amount equal to the income, war profits, or excess profits taxes paid by the foreign corporation with respect to income included in gross income under section 1248(a).

Subparagraph (B) of section 1248(b)(2) provides for an amount equal to a tax that would result by including in gross income of the individual U.S. person, as gain from the sale or exchange of a capital asset, an amount equal to the amount included in gross income in accordance with the provisions of section 1248(a), reduced by the amount determined under subparagraph (A) of section 1248(b)(2).

The application of section 1248(b)(2) may be illustrated by the following example involving individual U.S. person A who owns 100 percent of the stock of foreign corporation X. A purchased the stock of corporation X on January 1, 1963, and sold the stock on December 31, 1963. Corporation X files its income tax returns on a calendar year basis. For taxable year 1963, the entire income of corporation X was derived from the purchase and sale of property held for sale to customers in the ordinary course of trade or business. The profit or loss statement of corporation X is summarized as follows:

	1963
Gross receipts	$300,000
Cost of goods sold	125,000
Gross income	175,000
Rent, salaries, utilities, etc.	75,000
Taxable income	100,000
Foreign income tax (10 percent)	10,000
Earnings and profits	90,000

A realized $120,000 gain on the sale of the stock and was required, under the provisions of section 1248(a), to include $90,000 in gross income as a dividend and $30,000 as long-term capital gain. Without the application of section 1248(b), the tax attributable to the inclusion of $90,000 in gross income of A as a dividend was $63,000, an effective tax rate of 70 percent. The limitation of section 1248(b)(2) would be computed as follows:

(i) An amount determined under section 1248(b)(2)(A):		
(*a*) An amount determined under clause (i) of section 1248(b)(2)(A): Taxable income of corporation X under chapter 1 of the code, $100,000, upon which corporation X would have paid Federal income tax of	$46, 500	
(*b*) An amount determined under clause (ii) of section 1248(b)(2)(A): Income tax paid by corporation X	10, 000	
(*c*) The amount determined under subparagraph (A) is the excess of the amount determined under clause (i) over the amount determined under clause (ii) ((*a*) minus (*b*))		$36, 500
(ii) An amount determined under section 1248(b)(2)(B):		
(*a*) The amount included in gross income under section 1248(a)	$90, 000	
(*b*) The amount determined under subparagraph (A) of section 1248(b)(2)	36, 500	
(*c*) The amount treated as long-term capital gain for purposes of subparagraph (B) ((*a*) minus (*b*))	53, 500	
(*d*) Tax that would have resulted from including $53,500 in gross income as a long-term capital gain (25 percent of $53,500)		13, 375
(iii) The limitation of tax attributable to the inclusion of $90,000 in gross income as a dividend under section 1248(b)(2) is (item (i) plus (ii))		49, 875

Paragraph (3) of section 1248(b) provides for an alternative limitation of tax applicable to an amount includible in gross income of an individual U.S. person under section 1248(a) equal to the aggregate additional Federal income tax which would have been paid by the individual U.S. person had he included in gross income as a dividend his pro rata share of the undistributed earnings and profits of the foreign corporation for the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a controlled foreign corporation in taxable years of the foreign corporation beginning after December 31, 1962.

(c) *Special rules.*—Subsection (c) of section 1248 provides that certain amounts included in earnings and profits of a foreign corporation, determined in accordance with rules substantially similar to those applicable to domestic corporations, will be excluded from earnings and profits of the foreign corporation for purposes of section 1248.

Paragraph (1) of section 1248(c) correlates section 1248 with section 951 (added by sec. 12 of the bill) by reducing the amount of gain considered a dividend under subsection (a) by the U.S. person's proportionate share of earnings and profits of the foreign corporation, attributable to the stock sold or exchanged, which had been previously included in the gross income of the U.S. person by the application of subpart F of part III of subchapter N. However, such amounts previously included in the gross income of the U.S. person under section 951 are reduced by amounts, attributable to the stock sold or exchanged, subsequently distributed by the foreign corporation and excluded from gross income of the U.S. person under section 959.

The application of this paragraph may be illustrated by the following example involving U.S. corporation A which owns 100 percent of the stock of foreign corporation X. A purchased the stock on January 1, 1964, for $100 and sold the stock on January 1, 1966, for $115. For the year 1964, corporation X had earnings and profits, all of which was subpart F income, of $10, which was included in the gross income of A under section 951. Corporation X had no earnings and profits for the year 1965, but made a $5 distribution out of 1964 earnings and profits which was excludable from gross income of A under section 959. For the year 1966, A is required to include $10 in gross income as a long-term capital gain, which amount is computed as follows:

(i) Amount of gain:		
(*a*) Amount realized		$115
(*b*) Adjusted basis:		
Cost	$100	
Increase by amount included in gross income under section 951 (sec. 961(a))	10	
	110	
Reduced by amount excluded from gross income under section 959 (sec. 961(b))	5	
Adjusted basis		105
(*c*) Amount of gain ((*a*) minus (*b*))		10
(ii) Amount of gain includible in gross income of A as a dividend (sec. 1248(a)):		
(*a*) A's proportionate share of earnings and profits accumulated during the period the stock sold was held by A ($10 of earnings and profits for 1964, reduced by $5 distributed in 1965)	$5	
(*b*) A's proportionate share of earnings and profits previously included in the gross income of A under section 951 ($10) reduced by distributions excluded from the gross income of A under sec. 959, ($5)	5	
(*c*) Amount includible in gross income as a dividend ((*a*) minus (*b*))		0
(iii) Amount of gain from the sale of a capital asset held for more than 6 months (item (i) minus item (ii))		10

Paragraph (2) of section 1248(c), for which there is no corresponding provision in the bill as passed by the House, provides that if a foreign corporation realizes gain from the sale or exchange of property in pursuance of a plan of complete liquidation in a taxable year beginning after December 31, 1962, and if section 337(a) would apply if such corporation had been a domestic corporation, the earnings and profits attributable, under regulations prescribed by the Secretary of the Treasury or his delegate, to any net gain from the sale or exchange of property, as defined in section 337(b), will be excluded from earnings and profits of the foreign corporation for purposes of section 1248.

The application of paragraph (2) of section 1248(c) may be illustrated by an example involving foreign corporation X, wholly owned by U.S. person A. Corporation X, reporting its income on a calendar-year basis, adopted a plan of complete liquidation on January 1, 1963. During 1963, it sold all of its assets to M, and realized a gain of $300. The earnings and profits of corporation X for taxable year 1963 were $400, $100 attributable to operations and $300 attributable to the sale of all of its assets to M. Corporation X was completely liquidated on December 31, 1963, at which time all of its assets were distributed to A. A realized a gain of $500 on the exchange. Corporation X was not a collapsible corporation and section 332 did not apply to the liquidation; $100 of earnings and profits attributable to 1963 operations is includible in the gross income of A as a dividend under the provisions of section 1248(a), and $400 is includible in gross income of A as gain from the exchange of a capital asset.

Paragraph (3) of section 1248(c), for which there is no corresponding provision in the bill as passed by the House, provides for the exclusion from earnings and profits of a foreign corporation, for purposes of section 1248, of earnings and profits accumulated while the foreign corporation was a less developed country corporation, as defined in section 955(c), if the requirements of subparagraphs (A) and (B) are met.

Subparagraph (A) of section 1248(c)(3) provides that the foreign corporation whose stock is sold or exchanged must have qualified (1) as a less developed country corporation, as defined in section 955(c)(1) (added by sec. 13 of the bill), for all taxable years of such corporation beginning after December 31, 1962, for which the country under the laws of which the foreign corporation was created or organized was designated a less developed country under section 955(c)(3) (added by sec. 12 of your committee bill) or (2) as a less developed country corporation, as defined in section 955(c)(2), for all taxable years of such corporation beginning after December 31, 1962, for which the country under the laws of which the aircraft or vessels described in section 955(c)(2) were registered were designated less developed countries under section 955(c)(3).

The application of subparagraph (A) of section 1248(c)(3) may be illustrated by the following examples:

Example 1.—A, a U.S. person, acquired 100 percent of the stock of M, a foreign corporation incorporated under the laws of country X, on January 1, 1951, and sold the stock on December 31, 1965. Corporation M, a calendar year taxpayer, had earnings and profits of $100 in each of its taxable years 1951 through 1965. A realized a gain of $1,900 on the sale of corporation M stock. Country X was designated a less developed country for the year 1963, and corporation M qualified as a less developed country corporation for its 1963 taxable year. A is required to include $200 in gross income as a dividend under the provisions of section 1248(a) ($100 attributable to earnings and profits of taxable year 1964 and $100 attributable to earnings and profits of taxable year 1965). $1,700 of the total gain from the sale of M stock is includible in gross income as long-term capital gain. If foreign corporation X had been designated a less developed country for taxable years 1963 and 1964, but corporation M qualified as a less developed country corporation only for taxable year 1963, $300 of the gain would be includible in gross income of A as a dividend (all post-1962 earnings and profits) and $1,600 would be includible in gross income as long-term capital gain.

Example 2.—A, a U.S. person, owns 100 percent of the stock of foreign corporation M. Corporation M owns 100 percent of the stock of foreign corporation N. Corporation N's only asset in taxable year 1963 is a vessel registered under the laws of foreign country X. Foreign country X was designated a less developed country for taxable year 1963 and corporation N qualified as a less developed country corporation in that year. Corporation M's only income for 1963 was dividend income from corporation N and corporation N stock constituted the only asset of corporation M for taxable year 1963. Corporation M also qualified as a less developed country corporation for taxable year 1963. Corporation N sold its vessel on December 31, 1963, and purchased a replacement on January 1, 1965. Corporations M and N were not less developed country corporations for taxable year 1964 because Corporation N could not meet the income requirements of section 955(c)(2)(A) for such taxable year. Corporation N registered the vessel acquired January 1, 1965, in foreign country Y which was designated a less developed country for taxable year 1965. Corporations M and N qualified as less developed country corporations for taxable year 1965. A sold the stock in corporation M on December 31, 1965. The earnings and profits of corporation M accumulated in taxable years 1963 and 1965, are excluded from earnings and profits for purposes of section 1248 due to the fact the vessels from which the gross income described in section 955(c)(2) was derived were registered in less developed countries for all taxable years in which corporation N owned the vessels.

Subparagraph (B) of section 1248(c)(3) provides that a U.S. person who sells stock in a foreign corporation described in section 1248(c)(3)(A) must have owned the stock sold or exchanged for a continuous period of at least 10 years ending with the date of sale or exchange. If stock in a foreign corporation is sold by a U.S. person, other than a domestic corporation, such U.S. person must have owned the stock for the entire 10-year period. However, for purposes of subparagraph (B), the holding period of a U.S. person who is an individual, estate, or trust who acquired the stock sold or exchanged by reason of the death of an individual, shall be deemed to include the period the stock was held by the deceased individual, and by any other predecessor in interest if between such individual, estate, or trust, and such other predecessor in interest there was no transfer other than by reason of the death of an individual. If (1) the stock in a foreign corporation is sold by a U.S. person which is a domestic corporation, and (2) more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the domestic corporation was owned at any time during the 10-year period ending on the date of sale or exchange by U.S. persons who were individuals, estates, or trusts, then section 1248(c)(3) will apply only if the same such U.S. persons owned more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the domestic corporation at all times during the remainder of the 10-year period ending on the date of sale or exchange of the stock. However, only U.S. persons, other than domestic corporations, who own, within the meaning of section 958(a), or are considered as owning, by applying the rules of ownership of section 958(b), 10 percent or more of the stock in the domestic corporation which sells the stock in the foreign corporation will be taken into account in determining if 50 percent or more of the stock of the domestic corporation was owned at any time within the 10-year period ending on the date of sale or exchange by individuals, estates, or trusts, and if so held, has been held continuously by the same U.S. persons for the uninterrupted period ending with the date of sale or exchange.

Paragraph (4) of section 1248(c), for which there is no corresponding provision in the bill as passed by the House, provides that the earnings and profits of a foreign corporation, for purposes of section 1248, shall be determined without regard to any item includible in gross income of the foreign corporation under chapter 1 of the code as income derived from sources within the United States for the period or periods the foreign corporation was engaged in trade or business in the United States. This paragraph will not permit an exclusion in the case of U.S. source income of a controlled foreign corporation having no permanent establishment in the United States in situations (involving tax treaties) in which such permanent establishment is a requisite to imposition of U.S. tax, since in such a situation no amount will have been included in gross income for purposes of this paragraph.

Paragraph (5) of section 1248(c), for which there is no corresponding provision in the bill as passed by the House, correlates section 1248 with section 1247 by providing that the earnings and profits of the foreign corporation, for purposes of section 1248, shall exclude earnings and profits of the foreign corporation for any taxable year of such corporation with respect to which an election under section 1247(a) (added by sec. 14 of the bill) was in effect and for which the U.S. person whose stock is sold or exchanged was a qualified shareholder, as defined in section 1247(c) (added by sec. 14 of the bill).

The application of this paragraph may be illustrated by the following examples:

Example 1.—U.S. person X acquired 10 percent of the stock of foreign corporation A on January 1, 1962, and sold such stock on December 31, 1964. Corporation A, a calendar year taxpayer, was both a controlled foreign corporation, as defined in section 957, and a foreign investment company, as defined in section 1246(b)(1), but was not a foreign personal holding company, as defined in section 552, for taxable years 1962, 1963, and 1964. Corporation A had dividend income of $1,000 and an excess of net long-term capital gain over net short-term capital loss of $500 in each such taxable year (1962, 1963, and 1964). Corporation A made an election in accordance with the provisions of section 1247(a) with respect to taxable years 1963 and 1964 and distributed $900 to its shareholders in both such taxable years. X, by including $140 in gross income ($90 as a dividend and $50 as long-term capital gain) in taxable years 1963 and 1964, was a qualified shareholder, as defined in section 1247(c), for both such years. X realized a gain of $270 on the sale of his stock. Section 1246 does not apply to the sale; but section 1248(a) does apply. However, as applied to the facts of this case, section 1248(c)(5) provides that the earnings and profits, for purposes of section 1248, for taxable years 1963 and 1964 are zero and the entire gain, $270, is includible in gross income of X as long-term capital gain from the sale of a capital asset.

Example 2.—Assume the same facts as in example 1 above except that corporation A was not a foreign investment company as defined in section 1246(b)(1) for taxable year 1964 and X did not include in gross income any amount with respect to the income of corporation A in taxable year 1964. X's ratable share of the earnings and profits of corporation A, as provided by section 1246(a)(1), is includible in gross income of X as gain from the sale of property which is not a capital asset, and section 1248 does not apply because of subsection (d)(3)(B) of section 1248.

(d) *Exceptions.*—Subsection (d) of section 1248, which corresponds to paragraphs (4), (5), and (6) of section 1248(c) of the bill as passed by the House, provides that gain on the sale or exchange of stock in a foreign corporation shall not be includible in the gross income of the U.S. person if paragraph (1), (2), or (3) applies.

Paragraph (1) provides that section 1248 does not apply to a distribution of property to a U.S. person by a foreign corporation in redemption of part or all of the stock of such corporation to which section 303, relating to distributions in redemption of stock to pay death taxes, applies.

Paragraph (2) provides that section 1248 does not apply to gain recognized because of the receipt of additional consideration on exchanges to which section 356 applies.

Paragraph (3) provides that the amount includible in gross income as a dividend under section 1248(a) shall not include any amount treated as a dividend, as gain from the sale of an asset which is not a capital asset, or as gain from the sale of an asset held for not more than 6 months, under any other provision of the code.

(e) *Taxpayer to establish earnings and profits.*—Subsection (e) of section 1248 is the same as section 1248(d) of the bill as passed by the House, except for conforming and clarifying changes and the addition of a rule applicable to individuals whose Federal income tax is limited under the provisions of section 1248(b)(2).

Subsection (e) of section 1248 provides that the U.S. person selling or exchanging stock in a foreign corporation must establish the amount of earnings and profits of the foreign corporation to be taken into account under subsection (a), and the amount of foreign tax paid by the foreign corporation to be taken into account under subsection (b)(2). If the U.S. person does not establish the amount of earnings and profits to be taken into account, his entire gain will be treated as a dividend under subsection (a). If the U.S. person does not establish the amount of foreign taxes to be taken into account under subsection (b)(2), the limitation of tax of subsection (b)(2) shall not apply.

(b) *Clerical amendment.*—This subsection makes an addition to the table of contents of part IV of subchapter P of chapter 1.

(c) *Effective date.*—This subsection provides that the amendments made by section 15 shall apply with respect to sales or exchanges occurring after December 31, 1962. The bill as passed by the House provided that the amendments made by this section would apply with respect to sales or exchanges occurring after the date of the enactment of the bill.

SECTION 16. SALES AND EXCHANGES OF PATENTS, ETC., TO CERTAIN FOREIGN CORPORATIONS

Section 16 of the bill, for which there is no corresponding provision in the bill as passed by the House, adds a new section 1249 to part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses).

(a) *Treatment of gain as ordinary income.*—Under existing law certain exchanges described in sections 351 and 361 by a taxpayer of a patent or like property to a foreign corporation which the taxpayer controls may result in nonrecognition of gain if, before the exchange, under section 367 it has been established to the satisfaction of the Secretary of the Treasury or his delegate that the exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. However, if the taxpayer fails to establish that the exchange is not in pursuance of such a plan, or if a transfer by a taxpayer to a foreign corporation which he controls is an exchange other than one described in section 351 or 361, or is a sale, the gain recognized may constitute capital gain.

Subsection (a) of the new section 1249 applies to gain recognized from the sale or exchange after December 31, 1962, of a patent, invention, model, or design (whether or not patented), copyright, secret formula or process, or any similar property right by a U.S. person (as defined in sec. 7701(a)(30)) to a foreign corporation which such person controls. If such gain (but for the new subsection) would be capital gain from the sale or exchange of a capital asset or of property described in section 1231, then it is to be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

Subsection (b) defines control to mean, with respect to a foreign corporation, ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. The ownership rules of section 958 apply in determining whether control exists.

Subsection (c) provides that subsection (a) does not apply to gain realized from the sale or exchange for stock or contribution to capital of property where it is established to the satisfaction of the Secretary of the Treasury or his delegate that the principal purpose of the transfer is to enable the foreign corporation to use such property in its own manufacturing operations.

(b) *Clerical amendment.*—Subsection (b) of section 16 of the bill makes conforming changes to the table of sections for part IV.

(c) *Effective date.*—Subsection (c) of section 16 of the bill provides that section 1249 applies to taxable years beginning after December 31, 1962.

SECTION 17. TAX TREATMENT OF COOPERATIVES AND PATRONS

(a) *In general.*—Subsection (a) of section 17 of the bill amends the Internal Revenue Code of 1954 by adding to chapter 1 a new subchapter T (relating to cooperatives and their patrons) consisting of part I, tax treatment of cooperatives, part II, tax treatment by patrons of patronage dividends, and part III, definitions and special rules.

PART I—TAX TREATMENT OF COOPERATIVES

Part I of subchapter T consists of section 1381, organizations to which such part applies, section 1382, taxable income of cooperatives, and section 1383, computation of tax where cooperative redeems nonqualified written notices of allocation.

SECTION 1381. ORGANIZATIONS TO WHICH PART APPLIES

(a) *In general.*—Subsection (a) of section 1381 provides that part I of subchapter T is to apply to any organization which is exempt from tax under section 521 (relating to exemption of farmers' cooperatives) and to any corporation operating on a cooperative basis. Part I is not applicable, however, to any organization (1) which is exempt from income taxes (other than an exempt farmers' cooperative described in sec. 521); (2) which is subject to the provisions of part II of subchapter H (relating to mutual savings banks, etc.); (3) which is subject to the provisions of subchapter L (relating to insurance companies); or (4) which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas. Thus, part I of the new subchapter T does not apply to any cooperative exempt from tax under section 501. Nor does it apply to a cooperative which generates or transmits electricity for use by persons living in rural areas.

(b) *Tax on certain farmers' cooperatives.*—Subsection (b) of section 1381 provides that the farmers' cooperatives described in section 521 are subject to corporate income taxes. This is the same provision as the provision presently contained in section 522.

SECTION 1382. TAXABLE INCOME OF COOPERATIVES

(a) *Gross income.*—Subsection (a) of section 1382 provides that, except as provided in section 1382(b), all cooperatives to which part I of the new subchapter T applies must compute gross income without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) for amounts allocated or distributed to patrons out of net earnings.

(b) *Patronage dividends.*—Subsection (b)(1), applicable to both taxable and exempt cooperatives, provides that in determining the taxable income of a cooperative there are not to be taken into account certain patronage dividends paid in money, qualified written notices of allocation, or other property (other than nonqualified written notices of allocation). Under this subsection, the patronage dividends which are not to be taken into account in computing taxable income for a taxable year are those which are paid during the payment period for that taxable year (as defined in sec. 1382(d)) with respect to patronage occuring during such taxable year. For this purpose, under section 1382(d) a patronage dividend shall be treated as paid in money during the payment period to the extent it is paid by a qualified check (as defined in sec. 1388(c)(4)) issued during the payment period and endorsed and cashed on or before the 90th day after the close of the payment period.

Under subsection (b)(2), also applicable to both taxable and exempt cooperatives, certain amounts paid in money or other property (except written notices of allocation) in redemption of nonqualified written notices of allocation are not to be taken into account in determining the taxable income of a cooperative. The amounts described in subsection (b)(2) which are not to be taken into account for a taxable year are those which are paid during the payment period for that taxable year in redemption of nonqualified written notices of allocation which were paid as patronage dividends during the payment period for the taxable year during which the patronage occurred.

Subsection (b) also provides that amounts described in such subsection which are not taken into account in determining taxable income are to be treated for purposes of the 1954 Code in the same manner as items of gross income and corresponding deductions therefrom. Thus, for example, in determining the amount omitted from gross income for purposes of section 6501(e) (relating to period of limitations where there are omissions from gross income), amounts paid as patronage dividends (though not required to be taken into account in determining taxable income) are to be treated as amounts properly includible in gross income.

(c) *Deduction for nonpatronage distributions, etc.*—In the case of a farmers' cooperative which is exempt under section 521, certain deductions (in addition to other deductions allowed under ch. 1) are allowed under subsection (c) of the new section 1382. Subsection (c)(1) allows a deduction for dividends paid by such a cooperative during the taxable year on its capital stock. This deduction is the same in substance as that currently allowed under section 522(b)(1)(A).

Subsection (c)(2)(A) allows a deduction for amounts paid (or treated as paid under sec. 1382(d)) during the payment period for a taxable year, on a patronage basis, out of earnings of that taxable year derived either from business done for the United States or from sources other than patronage. A deduction is allowed by subsection (c)(2)(A), however, only for amounts paid in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation). For purposes of the deduction allowed by subsection (c)(2)(A), amounts are considered as paid on a patronage basis if they are paid in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such amounts are attributable.

In addition to the deductions allowed by subsections (c)(1) and (c)(2)(A), a deduction is allowed under subsection (c)(2)(B) for amounts paid in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was previously paid during the payment period for a taxable year on a patronage basis to a patron out of earnings derived during that taxable year either from business done for the United States or from sources other than patronage. A deduction under subsection (c)(2)(B) will be allowed for a taxable year only for amounts paid during the payment period for that taxable year.

For purposes of the new subchapter T, a written notice of allocation is considered paid when it is issued to the patron. Amounts paid in redemption of a nonqualified written notice of allocation which are in excess of the stated dollar amount of such written notice of allocation and which in effect constitute interest may be deducted by the cooperative as interest. These excess amounts will be treated by the distributee as interest and not as a patronage dividend.

(d) *Payment period for each taxable year.*—Subsection (d) of section 1382 contains the definition of the "payment period for each taxable year." It provides that the payment period for any taxable year is the period beginning with the 1st day of such taxable year and ending with the 15th day of the 9th month following the close of such year. Thus, a cooperative has 8½ months after the close of a taxable year in which to pay patronage dividends out of the net earnings from patronage occurring during that taxable year. Any patronage dividend which it pays after that time must be taken into account by the cooperative in computing its taxable income; and the cooperative will be allowed no subsequent adjustment for any amount it pays in redemption of a written notice of allocation which was paid as a part of such patronage dividend. The same general rules apply with respect to nonpatronage distributions made on a patronage basis. Subsection (d) also provides that, for purposes of section 1382 (b)(1) and (c)(2)(A), a qualified check shall be treated as an amount paid in money during the payment period for a taxable year if it is issued during such payment period and is endorsed and cashed on or before the 90th day after the close of such payment period.

(e) *Products marketed under pooling arrangements.*—Subsection (e) of section 1382 provides a special rule for determining, for purposes of section 1382(b), when the patronage is considered to have occurred in the case of a pooling arrangement for the marketing of products. Under this rule, the patronage will (to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate) be treated as occurring during the taxable year in which the pool closes. For example, farmer A delivers to the X cooperative 100 bushels of wheat on August 15, 1963, at which time he receives a "per bushel" advance. On October 15, 1963, he receives an additional "per bushel" payment. The pool sells some of its wheat in 1963 and the rest in January of 1964. The pool is closed on February 15, 1964. For purposes of section 1382(b), A's patronage is considered as occurring in 1964.

Section 1382 has no effect on, and is not intended to change, existing rules with respect to the time at which items are taken into account in computing the cooperative's gross income. For example, a tobacco stabilization cooperative may be required by the Commodity Credit Corporation to apply a portion of its proceeds from the sale of tobacco against loans on other crop years. In a letter to the Department of Agriculture dated October 11, 1955, the Internal Revenue Service held that this portion of the proceeds was not includible in the cooperative's gross income until the cooperative had an unrestricted right to such portion. Section 1382 will in no way change this holding. Under section 1382(f), the Secretary of the Treasury or his delegate may provide by regulations that, in such a case, the patronage to which this portion of the proceeds relates is to be considered to have occurred during the taxable year when the cooperative first had an unrestricted right to such portion. This will permit the cooperative to pay these proceeds out as patronage dividends during the payment period for such later year. If the conditions of section 1382(b) are met, such patronage dividends need not be taken into account in determining the taxable income of the cooperative for such later year. Section 1382(f) permits the Secretary of the Treasury or his delegate to provide similar rules as to when patronage is considered to have occurred in other cases when earnings are includible in the gross income of a cooperative for a taxable year after the patronage occurred.

SECTION 1383. COMPUTATION OF TAX WHERE COOPERATIVE REDEEMS NONQUALIFIED WRITTEN NOTICES OF ALLOCATION

Section 1383 provides a special rule for computing a cooperative's tax for a year when it redeems nonqualified written notices of allocation.

(a) *General rule.*—Section 1383(a) provides that if, for a taxable year, a cooperative is allowed a deduction under section 1382 (b)(2) or (c)(2)(B) for amounts it pays in redemption of nonqualified written notices of allocation, then its tax for that year shall be whichever of the following is the smaller:

(1) The tax for the taxable year computed with the deduction for the amounts paid in redemption of the nonqualified written notices of allocation, or

(2) An amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under chapter 1 for the 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.*—Section 1383(b) provides three special rules applying to the alternative tax computations based on the decrease in tax for the prior taxable years. Under section 1383(b)(1), if the decrease in tax for the prior taxable year (or years) exceeds the tax for the current year (computed without any deduction for amounts paid in redemption of nonqualified written notices of allocation), the excess is to be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the current taxable year, and is to be refunded or credited in the same manner as if it were an overpayment for the current taxable year.

Section 1383(b)(2) provides that, for purposes of computing the decrease in tax for the prior taxable year, the nonqualified written notices of allocation which are treated as qualified written notices of allocation are to be considered to have a stated dollar amount equal to the amount paid in redemption of such written notices of allocation to the extent such amount is allowable as a deduction under section 1382 (b)(2) or (c)(2)(B).

Section 1383(b)(3) provides that if the alternative tax computation provided by section 1383(a)(2) is used, then the deduction otherwise allowable for the current year by reason of the redemption of nonqualified written notices of allocation is not to be allowed for any purpose under the 1954 Code.

The application of section 1383 may be illustrated by the following example:

The X cooperative (which reports its income on a calendar year basis) pays patronage dividends of $100 in nonqualified written notices of allocation on February 1, 1964, with respect to patronage occurring in 1963. Since the patronage dividends were paid in nonqualified written notices of allocation, the X cooperative must include the $100 in gross income and is not allowed a deduction for that amount for 1963. On December 1, 1966, the X cooperative redeems these nonqualified written notices of allocation for $50. Section 1382(b)(2) permits, in effect, the X cooperative to deduct that $50 from gross income in determining its taxable income for 1966. However, if the X cooperative otherwise has a loss for 1966 and, therefore, owes no tax for that year, it may make the computation under the alternative method provided in section 1383(a)(2). Under this alternative, it would be permitted a credit or refund of the decrease in tax for 1963 which results from recomputing the 1963 tax liability as if patronage dividends of $50 had been paid for 1963 in qualified written notices of allocation. If this alternative is used, the X cooperative cannot then use the $50 deduction otherwise allowable for 1966 to increase its net operating loss carryback or carryforward. If the X cooperative also redeems on December 1, 1966, nonqualified written notices of allocation which were paid as patronage dividends on February 1, 1965, with respect to patronage occurring in 1964, it would be allowed a credit or refund for the decrease in tax for 1964. It could not, however, apply one method for computing the tax with respect to the redemption in 1966 of the nonqualified written notices of allocation paid in 1964 and the other method with respect to the redemption in 1966 of the nonqualified written notices of allocation paid in 1965.

PART II—TAX TREATMENT BY PATRONS OF PATRONAGE DIVIDENDS

Part II of subchapter T, consisting of section 1385, deals with the patron's tax treatment of patronage dividends and amounts paid by an exempt farmers' cooperative from nonpatronage earnings.

SECTION 1385. AMOUNTS INCLUDIBLE IN PATRON'S GROSS INCOME

(a) *General rule.*—Subsection (a)(1) requires the patron to include in gross income the amount of any patronage dividend (other than one described in sec. 1385(b)) received during the taxable year from a taxable or an exempt cooperative to which part I of subchapter T applies, if paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation). Subsection (a)(2) requires inclusion in the gross income of the patron of distributions (other than those paid in nonqualified written notices of allocation) paid on a patronage basis by a farmers' cooperative exempt under section 521 with respect to earnings derived either from business done for the United States or from sources other than patronage. The patron must include patronage dividends in gross income for the taxable year during which they are received, even though the adjustment in computing taxable income of the cooperative was made for its preceding taxable year because they were paid during the payment period for such preceding taxable year. Patronage dividends are includible in the patron's gross income under section 1385 even if the cooperative is not permitted any adjustment for such patronage dividends because they were not paid during the payment period for the taxable year in which the patronage occurred.

(b) *Exclusion from gross income.*—Subsection (b)(1) of section 1385 excludes from gross income a patronage dividend, or an amount received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was previously paid as a patronage dividend, which is properly taken into account as an adjustment to basis of property. For example, if a patronage dividend is attributable to the purchase of a capital asset or property used in a trade or business, such patronage dividend will not be included in the distributee's gross income but will reduce the basis of such asset or property. Subsection (b)(2) provides that a patronage dividend, or an amount received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was previously paid as a patronage dividend, which is paid to a patron with respect to the purchase of a personal, rather than a business, expense item, is not includible in gross income. These provisions are to be applied under regulations prescribed by the Secretary of the Treasury or his delegate.

(c) *Treatment of certain nonqualified written notices of allocation.*—Subsection (c)(1) of section 1385 describes the kind of nonqualified written notices of allocation to which section 1385(c) applies. This subsection applies to a nonqualified written notice of allocation which was paid as a patronage dividend by a taxable or an exempt cooperative, and to a nonqualified written notice of allocation which was paid on a patronage basis by a farmers' cooperative exempt under section 521 out of earnings derived either from business done for the United States or from sources other than patronage.

Subsection (c)(2)(A) of section 1385 provides that such a nonqualified written notice of allocation is to have a zero basis in the hands of the patron to whom it was paid. Subsection (c)(2)(B) of section 1385 provides that the basis of a nonqualified written notice of allocation described in subsection (c)(1) acquired from a decedent is to be its basis in the hands of the decedent. Any amount which the beneficiary is required to report as ordinary income on the redemption, sale, or other disposition of such written notice of allocation is income in respect of a decedent under section 691 of the code. Subsection (c)(2)(C) provides that any gain on the redemption, sale, or other disposition of a nonqualified written notice of allocation described in subsection (c)(1) is to be ordinary income to the extent that its stated dollar amount exceeds its basis. This is true whether such gain is realized by the patron who received the nonqualified written notice of allocation or any subsequent holder. For example, farmer A receives a patronage dividend paid in the form of a nonqualified written notice of allocation which is attributable to the sale of his crop to the X cooperative. The stated dollar amount of the nonqualified written notice of allocation is $100. The basis of the written notice of allocation in the hands of farmer A is zero and he must report any amount up to $100 received by him on its redemption, sale, or other disposition as ordinary income. If farmer A gives the written notice of allocation to his son B, B takes farmer A's (the donor's) basis which is zero, and any gain up to $100 which B later realizes on its redemption, sale, or other disposition is ordinary income. Similarly, if A dies before realizing any gain on the nonqualified written notice of allocation, B, his legatee, has a zero basis for such written notice of allocation and any gain up to $100 which he then realizes on its redemption, sale, or other disposition is also ordinary income. Any amounts realized on the redemption, sale, or other disposition of such nonqualified written notice of allocation in excess of $100 will be treated under the applicable provisions of the code. These provisions in section 1385(c)(2)(C) are not intended to reflect in any way on how gain on the redemption, sale, or other disposition of a written notice of allocation would be treated under existing law.

Part III—Definitions; Special Rules

Part III of subchapter T, consisting of section 1388, defines "patronage dividend," "written notice of allocation," "qualified written notice of allocation," "qualified check," and "nonqualified written notice of allocation," and provides special rules for determining amounts paid or received.

SECTION 1388. DEFINITIONS; SPECIAL RULES

(a) *Patronage dividend.*—Under subsection (a) of section 1388, the term "patronage dividend" means an amount paid to a patron by a cooperative to which part I of subchapter T applies (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation to pay such amount, which obligation existed before the cooperative received the amount, and (3) which is determined by reference to the net earnings of the cooperative from business done with or for its patrons. It is made clear that there are not to be included as patronage dividends any amounts which are out of earnings other than from business done with or for patrons, or any amounts paid to patrons which are attributable to the patronage of other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. Thus, if a cooperative does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend.

(b) *Written notice of allocation.*—The term "written notice of allocation" is defined in subsection (b) of section 1388 to mean 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, and the portion thereof, if any, which constitutes a patronage dividend.

This definition is applicable both to written notices of allocation paid as patronage dividends and to written notices of allocation paid with respect to nonpatronage earnings or earnings from business done for the United States.

(c) *Qualified written notice of allocation.*—Subsection (c)(1) of section 1388 contains the definition of "qualified written notice of allocation". Subsection (c)(1)(A) provides, in the case of both taxable and exempt cooperatives, that the term "qualified written notice of allocation" includes a written notice of allocation which the patron may redeem in cash, at 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. The patron must be notified by the cooperative, in writing, at the time he receives the written notice of allocation, of this right of redemption. It is intended that this notice must be given separately to each patron and not in the form of a notice in a newspaper or posted at the cooperative's headquarters. If the patron does not exercise his option to redeem the written notice of allocation, he must, nevertheless, take it into account, at its stated dollar amount, in the manner provided in section 1385(a).

Subsection (c)(1)(B) of section 1388, also applicable to both taxable and exempt cooperatives, provides that the term "qualified written notice of allocation" also includes a written notice of allocation which the patron has consented to take into account at its stated dollar amount in the manner provided in section 1385(a). This consent must be made in the manner provided in subsection (c)(2) of section 1388.

Subsection (c)(1) provides, however, that a written notice of allocation is not "qualified" unless at least 20 percent of the patronage dividend, or the payment with respect to nonpatronage earnings or earnings from business done for the United States, of which it is a part, is paid in money or by qualified check (as defined in sec. 1388(c)(4)). Thus, even though the patron has consented to take the face amount of a written notice of allocation paid as part of a patronage dividend into account as provided in section 1385(a), or such allocation is redeemable for cash at any time within a period of at least 90 days, such written notice of allocation will not be qualified unless at least 20 percent of the patronage dividend is paid in money or by qualified check.

Subsection (c)(2) of section 1388 provides the three different ways in which the consent to take written notices of allocation into account as provided in section 1385(a) may be made. The first way is to make such consent in writing. (This does not include a consent made by endorsing and cashing a qualified check which is described in subsection (c)(2)(C).) The written consent must be made by the patron before the close of the cooperative's taxable year during which the patronage to which the written notice of allocation is attributable occurred. Such consent is, under subsection (c)(3)(A)(i), effective with respect to all patronage occurring during the taxable year of the cooperative in which such consent is made and, unless revoked as provided in subsection (c)(3)(B)(i), all subsequent taxable years. Subsection (c)(3)(B)(i) provides that such a consent may be revoked by the patron at any time. The revocation must be in writing and filed with the cooperative. Thus, any such written consent which is, by its terms, irrevocable is not a consent that would qualify a written notice of allocation under subsection (c)(1)(B). A revocation is only effective with respect to patronage occurring after the close of the cooperative's taxable year during which the revocation is filed with it. In the case of a patron participating in a pooling arrangement described in section 1382(e), a written consent may be made at any time before the close of the cooperative's taxable year during which the pool closes. Any subsequent revocation filed by the patron, however, would not be effective with respect to that pool.

Subsection (c)(2)(B) describes another way the consent can be given by a patron who is a member (or prospective member) of the cooperative. In this case, the consent may be made by the patron by obtaining or retaining membership in the cooperative after—

(A) the cooperative has adopted a bylaw providing that membership in the cooperative constitutes such consent, and

(B) he has received a written notification and copy of such bylaw.

The bylaw described in (A) must be adopted by the cooperative after the date of enactment of this bill (the Revenue Act of 1962) and must contain a clear statement that membership in the cooperative constitutes the prescribed consent. The following is an example of a bylaw provision which would meet this requirement:

> Each person who hereafter applies for and is accepted to membership in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to his patronage occurring after ----------, which are made in written notices of allocation (as defined in 26 U.S.C. 1388) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such written notices of allocation are received by him.

Before a patron shall be considered to have consented under this second alternative, he must receive the written notification and the copy of the bylaw, as provided in (B) above. In the case of a new member, he must receive the notification and the copy of the bylaw before he becomes a member. The written notification must inform the patron that this bylaw has been adopted and of its significance. It is intended that the notification and copy of the bylaw must be given to each individual separately and not in the form of a notice in a newspaper or posted at the cooperative's headquarters.

Under subsection (c)(3)(A)(ii) of section 1388, this alternative consent will be effective with respect to all patronage of the member-patron occurring after he receives the notification and copy of the bylaw provision. In the case of a pooling arrangement described in section 1382(e), the consent will only be effective with respect to the member's actual patronage occurring after he receives the notification and copy of the bylaw and shall not be effective with respect to any of his patronage under the pool before this time. Subsection (c)(3)(B)(ii) provides that this alternative consent will not apply to any patronage of the patron after he ceases to be a member of the cooperative or after the bylaw provision is repealed by the cooperative. In the case of a pooling arrangement, this refers to the time when the patronage actually occurred. Thus, if the patron resigns his membership in the cooperative during the period a pool is in operation, he will not be considered to have consented with respect to any of his patronage under the pool after the date of his resignation.

Subsection (c)(2)(C) describes the third way that a patron may consent to take a written notice of allocation into account as provided in section 1385(a). Under this alternative, the consent may be given by endorsing and cashing a qualified check (as defined in subsec. (c)(4)) which is paid as part of the same patronage dividend, or the same distribution with respect to nonpatronage earnings, as is the written notice of allocation.

Subsection (c)(4) defines a qualified check to mean only a check, or other instrument redeemable in money, (1) which is paid as a part of a patronage dividend, or as a part of a payment described in section 1382(c)(2)(A), to a patron who has not already given consent in the manner provided in subsection (c)(2) (A) or (B) with respect to such patronage dividend or such payment, and (2) on which there is clearly imprinted a statement that the endorsement and cashing of the check (or other instrument) constitutes the consent of the payee to take into account, as provided in the Federal income tax laws, the stated dollar amount of any written notices of allocation which are paid as a part of the patronage dividend or payment of which such check (or other instrument) is also a part. The term "qualified check" does not include a check or other instrument which is paid as part of a patronage dividend or payment which does not include a written notice of allocation (other than one described in sec. 1388(c)(1)(A)). Thus a check which is paid as part of a patronage dividend is not a "qualified check" (even though it has the above-described statement imprinted on it) if the remaining portion of such patronage dividend is paid in cash or if the only written notices of allocation included in the distribution are redeemable allocations which are considered qualified under section 1388(c)(1)(A). Under this definition, it is not necessary that a qualified check be in the form of an ordinary check which is payable through the banking system. It may, for example, be in the form of an instrument which may be redeemed by the cooperative for money.

In order to constitute consent, a qualified check must be cashed by the payee on or before the 90th day after the close of the payment period for the taxable year of the cooperative for which the patronage dividend, or the distribution with respect to nonpatronage earnings, is paid. Thus, in the case of a cooperative on a calendar year basis, which pays patronage dividends for 1963 in qualified checks and written notices of allocation, only those patrons who cash their qualified checks on or before December 14, 1964, shall be considered to have consented under subsection (c)(2)(C) with respect to the written notices of allocation. For purposes of determining whether or not the cooperative is required to take the amount of a qualified check into account in computing its taxable income under section 1382 (b)(1) or (c)(2)(A), section 1382(d) provides that those qualified checks which are issued during the payment period for the taxable year and which are endorsed and cashed on or before the 90th day after the close of such period shall be treated as amounts paid in money during such payment period. Thus, in the above example, if the qualified checks were issued on or before September 15, 1964, then the amount of those checks which are cashed on or before December 14, 1964, shall be treated, for purposes of section 1382(b)(1), as patronage dividends paid in money during the payment period for 1963.

Under the above example, in the case of a patron who has not cashed his qualified check by December 14, 1964, there is no consent and both the written notice of allocation and the qualified check constitute nonqualified written notices of allocation. Therefore, as of that date, the patron is not required to include any amount in gross income, and the cooperative is allowed no deduction, with respect to either the qualified check or the written notice of allocation. If the payee cashes his check on January 2, 1965, he shall treat the amount received for tax purposes as an amount received on January 2, 1965, in redemption of a nonqualified written notice of allocation. Likewise, the cooperative shall treat the amount of the check as an amount paid on January 2, 1965, in redemption of a nonqualified written notice of allocation. The written notice of allocation itself will be treated in the same manner as any other nonqualified written notice of allocation; that is, nothing will be includible in the gross income of the patron and no deduction will be allowed the cooperative until the written notice of allocation is redeemed.

Since the term "qualified check" includes only checks or other instruments issued to patrons who have not otherwise consented with respect to the distribution of which the check or other instrument is a part, the endorsing and cashing of a check which contains a statement that this constitutes consent by a patron of a cooperative shall have no effect as a consent if such patron is already considered as having consented by reason of subsection (c)(2) (A) or (B) with respect to the distribution of which such check is a part.

Endorsing and cashing a qualified check shall be considered a consent only with respect to the written notices of allocation which are paid as part of the same distribution as is the qualified check.

(d) *Nonqualified written notice of allocation.*—Subsection (d) of section 1388 defines "nonqualified written notice of allocation" to mean (1) a written notice of allocation which is not described in subsection (c) and (2) a qualified check which is not cashed on or before the close of the 90th day after the close of the payment period for the taxable year (of the cooperative) for which the distribution of which it is a part is paid.

(c) *Determination of amount paid or received.*—Subsection (c) of section 1388 provides that, for purposes of the new subchapter T, in determining amounts paid or received: (1) Property, other than a written notice of allocation, is to be taken into account at its fair market value, and (2) a qualified written notice of allocation is to be taken into account at its stated dollar amount. Thus, if a cooperative pays part of its patronage dividends in qualified written notices of allocation, and the requirements of section 1382 are met, the cooperative will not be required to take the stated dollar amounts of such written notices of allocation into account in determining its taxable income. Conversely, the patron receiving a qualified written notice of allocation must take it into account, as provided in section 1385(a), at its stated dollar amount. If a cooperative pays a patronage dividend in nonqualified written notices of allocation, it is required to include the stated dollar amount thereof in gross income and is allowed no deduction (and the patrons are not required to include such amount in gross income) at the time such written notices of allocation are paid (or received).

SECTION 17. TAX TREATMENT OF COOPERATIVES AND PATRONS (Continued)

(b) *Technical amendments.*—Subsection (b) of section 17 of the bill makes certain technical amendments to reflect the provisions of the new subchapter T.

Paragraph (1) amends section 521(a) (relating to exemption of farmers' cooperatives from tax) to insert references to part I of the new subchapter T.

Paragraph (2) repeals section 522 (relating to tax on farmers' cooperatives exempt under sec. 521).

Paragraph (3) amends section 6072(d) (relating to time for filing income tax returns of exempt cooperative associations) to extend the time for filing income tax returns of certain taxable cooperatives. Under this amendment, these cooperatives need not file returns for a taxable year until the 15th day of the 9th month following the close of such taxable year. Under existing law, these nonexempt cooperatives must file returns for a taxable year on or before the 15th day of the 3d month following the close of such taxable year. The taxable cooperatives which may take advantage of this filing date provision are those described in section 1381(a)(2) which either (1) are under an obligation to pay patronage dividends in an amount equal to 50 percent or more of net earnings from business done with or for patrons, or (2) actually paid patronage dividends in such an amount out of net earnings from business done with or for patrons during the most recent taxable year for which they had such net earnings. Under existing law, exempt farmers' cooperatives are not required to file returns for a taxable year until the 15th day of the 9th month following the close of such taxable year, and this rule is not changed.

(c) *Effective dates.*—Subsection (c) of section 17 of the bill prescribes the effective dates for subsections (a) and (b).

Paragraph (1) of subsection (c) provides that, in the case of cooperatives, the amendments made by subsections (a) and (b) will, except as provided in paragraph (3), apply to taxable years of organizations described in section 1381(a) beginning after December 31, 1962.

Paragraph (2) of subsection (c) provides that, in the case of patrons, section 1385 will, except as provided in paragraph (3), apply with respect to any amount received from any organization described in section 1381(a), to the extent that such amount is paid by such organization in a taxable year of such organization beginning after December 31, 1962.

Paragraph (3) of subsection (c) provides that, in the case of any money, written notices 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 notices of allocation, or other property (including the tax treatment of gain or loss on the redemption, sale, or other disposition of such written notices of allocation) by any cooperative or patron is to be made under the 1954 Code without regard to the new subchapter T. For example, if a cooperative pays a patronage dividend during its taxable year beginning January 1, 1963, out of net earnings for its taxable year ending on December 31, 1962, the tax treatment of such a patronage dividend (including the determination of when it is considered paid) would be determined under existing law. Furthermore, the provisions of section 1382 (b)(2) and (c)(2)(B) (relating to deduction for amounts paid in redemption of certain nonqualified written notices of allocation) and section 1383 (relating to computation of tax where a cooperative redeems nonqualified written notices of allocation) are not applicable to amounts paid in redemption of a written notice of allocation which was paid (whether before or after January 1, 1963) with respect to patronage occurring before such date.

SECTION 18. INCLUSION OF FOREIGN REAL PROPERTY IN GROSS ESTATE

This section of the bill is the same as section 18 of the bill as passed by the House, except that the special provisions discussed below in subsection (b), which under the bill as passed by the House were applicable in the case of decedents dying after the date of enactment and before July 1, 1964, are changed by your committee so as to be applicable in the case of decedents dying after the date of enactment and before January 1, 1963.

(a) *Amendments to include foreign real property.*—Subsection (a) of section 18 of the bill amends sections 2031(a), 2033, 2034, 2035(a), 2036(a), 2037(a), 2038(a), 2040, and 2041(a) of the 1954 Code by striking from each section the language which requires the exclusion from the gross estate of real property situated outside of the United States. The result of these amendments, subject to the effective date provisions of subsection (b) of section 18, is to include in the gross estate of decedents who are citizens or residents of the United States, the fair market value of their interest in real property which is situated outside of the United States. Under existing law real property situated outside of the United States is excluded in determining the value of the gross estate.

(b) *Effective date.*—Subsection (b) of section 18 provides that the amendments which repeal the exclusion for real property situated outside of the United States are effective with respect to the estates of decedents dying after the date of the enactment of the bill. However, special provisions apply in the case of decedents dying after such date of enactment and before January 1, 1963.

Under one of these provisions, the value of real property situated outside of the United States is not included in the gross estate of the decedent under section 2033, 2034, 2035(a), 2036(a), 2037(a), or 2038(a) to the extent the decedent's interest in it was acquired before February 1, 1962. Under another of these special provisions, the value of real property situated outside the United States is excluded from the gross estate of a decedent who dies after the date of the enactment of the bill and before January 1, 1963, to the extent the property or interest therein was either held by the decedent and the surviving tenant in a joint tenancy or tenancy by the entirety before February 1, 1962, or, even though the joint tenancy or tenancy by the entirety was created on or after February 1, 1962, to the extent the property or interest therein was acquired by the decedent before February 1, 1962. Under still another of these special provisions, in the case of decedents dying after the date of the enactment of the bill and before January 1, 1963, the value of real property situated outside the United States is excluded from the gross estate to the extent that before February 1, 1962, it was subject to a general power of appointment possessed by the decedent.

For purposes of applying these three special provisions, the real property, interests therein, and general powers of appointment to which these special provisions apply, which are 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), are treated as acquired before February 1, 1962, if the donor or prior decedent acquired the property, his interest therein, or a power of appointment (whether or not a general power) in respect thereof, before that date. For example, assume that A, who bought foreign real property on December 1, 1961, dies on March 1, 1962, and by will leaves the property to B who dies after the date of the enactment of the bill and before January 1, 1963. In this example B will be treated as having acquired the property before February 1, 1962, since A, the prior decedent from whom B acquired the property, had acquired it before February 1, 1962.

For purposes of the amendments made by section 18(b) of the bill, substantial capital additions and improvements to real property made after January 31, 1962, are to be treated as separate properties. Capital additions or improvements to either commercial or residential property which do not materially increase the value of the property are to be disregarded.

SECTION 19. REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR

Section 19 of the bill as passed by the House provided a system for the withholding of tax at the source on interest, dividends, and patronage dividends. Your committee has struck out those provisions and has inserted provisions which would require annual information reporting of certain dividend, interest, or patronage dividend payments. Such reporting is to be required with respect to payments to any person when they aggregate $10 or more in amount to such person in any calendar year. In addition, your committee has added provisions requiring that payers of interest, dividends, or patronage dividends furnish to the recipients of these amounts annual statements showing the amounts paid to them as reported on the information returns filed with the Government. New penalty provisions are provided by your committee for failure to file information returns with respect to payments of interest, dividends, or patronage dividends and for failure to furnish to a recipient of such payments an annual statement of such payments.

(a) *Returns regarding payment of dividends and corporate earnings and profits.*—Subsection (a) of the new section 19 completely revises section 6042 of the 1954 Code (relating to returns regarding corporate dividends, earnings, and profits). Under existing section 6042 of the code the Secretary of the Treasury or his delegate has discretionary authority to require corporations to make information returns, with respect to their payments of dividends, showing the name and address of, the number of shares owned by, and the amount of dividends paid to, each shareholder. In addition, the Secretary of the Treasury or his delegate may require corporations to furnish other specified information, such as statements of accumulated earnings and profits, the names and addresses of shareholders who would be entitled to such earnings and profits if they were distributed, and the amounts that would be payable to each.

SECTION 6042. RETURNS REGARDING PAYMENT OF DIVIDENDS AND CORPORATE EARNINGS AND PROFITS

(a) *Requirement of reporting.*—Subsection (a)(1) of the new section 6042 requires every person making payments of dividends aggregating $10 or more to any other person during any calendar year to file an information return with respect to such payments. In addition, such new subsection requires persons receiving payments of dividends in the capacity of nominee to report payments by them aggregating $10 or more during any calendar year to any other person with respect to the dividends so received. Thus, if an individual has his stock registered in the name of his stockbroker, the stockbroker must file an information return showing the name and address of the individual and the amount of dividends he received and paid over to, or credited to the account of, such individual during the calendar year if they amount to $10 or more. The return to be filed under section 6042(a)(1) is to be made according to the forms or regulations prescribed by the Secretary of the Treasury or his delegate and is to set forth the name and address of the person to whom the payments were made and the aggregate amount of such payments.

Section 6042 only requires reporting with respect to dividends paid by one "person" to another "person." For purposes of this section (and secs. 6044, as amended by the bill, and 6048, as added by the bill) the term "person" has the meaning assigned to it by section 7701(a)(1) of the code. Under that section the term "person" does not include the United States, a State, a foreign government, a political subdivision of a State or foreign government, or an international organization. Therefore, dividends (and patronage dividends and interest) paid by or to one of these entities need not be reported. The person required to report under subsection (a)(1) is the person on whose capital stock the dividends are paid. The term "payment" includes constructive payment. Thus, dividends which are credited to the account of a shareholder by a mutual fund must be reported by the fund if they aggregate $10 or more during the calendar year. The term "nominee" does not include a partner acting with respect to property of a partnership of which he is a member or a person who, acting in the capacity of trustee, holds record title to trust property. The general rules discussed in this paragraph are also applicable with respect to the new reporting requirements for interest and patronage dividends.

Subsection (a)(2) of the new section 6042 gives the Secretary of the Treasury or his delegate discretion to require information returns to be filed with respect to dividend payments aggregating less than $10 during a calendar year.

(b) *Dividend defined.*—Subsection (b)(1) of the new section 6042 defines the term "dividend" for purposes of section 6042 to mean: (A) any distribution by a corporation which is a dividend as defined in section 316 of the code; and (B) any payment made by a stockbroker to any person as a substitute for a dividend (as so defined). Reporting is required whether a dividend is paid in cash or in other property. A dividend paid by an insurance company to a policyholder, other than a dividend upon the capital stock of such insurance company, is not a dividend within the meaning of section 6042(b)(1).

Subsection (b)(2) of the new section 6042 provides that the term "dividend," for purposes of section 6042, does not include: (A) to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, any distribution or payment (i) by a foreign corporation, or (ii) to a foreign corporation, a nonresident alien, or a partnership not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens; or (B) any amount described in section 1373 of the code (relating to undistributed taxable income of electing small business corporations).

Subsection (b)(3) provides that if the person making any payment described in subsection (a)(1) is unable to determine the portion of the payment which is a dividend or is paid with respect to a dividend, the total amount of the payment is to be treated as a dividend for purposes of information reporting required by subsection (a)(1). Thus, if a corporation is unable to determine what portion of its distributions to its shareholders during the calendar year is paid out of earnings and profits, the total amount of the distributions must be treated as a dividend.

(c) *Statements to be furnished to persons with respect to whom information is furnished.*—Subsection (c) of the new section 6042 requires every person making a return under subsection (a)(1) of section 6042 to furnish to each person whose name is set forth in such return a written statement showing (1) the name and address of the person making the return, and (2) the aggregate amount paid to the person as shown on the return. Such written statement is to be furnished to the person on or before January 31 of the year following the calendar year for which the return was made. However, no statement is required to be furnished to any person under this subsection if the aggregate amount of payments to the person as shown on the return made under subsection (a)(1) is less than $10.

(d) *Statements to be furnished by corporations to Secretary.*—Subsection (d) of the new section 6042 provides that every corporation shall, when required by the Secretary of the Treasury or his delegate—

(1) furnish to the Secretary of the Treasury or his delegate a statement stating the name and address of each shareholder, and the number of shares owned by each shareholder;

(2) furnish to the Secretary of the Treasury or his delegate a statement of such facts as will enable him to determine the portion of the earnings and profits of the corporation (including gains, profits, and income not taxed) accumulated during such periods as the Secretary of the Treasury or his delegate may specify, which have been distributed or ordered to be distributed, respectively, to its shareholders during such taxable years as the Secretary of the Treasury or his delegate may specify; and

(3) furnish to the Secretary of the Treasury or his delegate a statement of its accumulated earnings and profits and the names and addresses of the individuals or shareholders who would be entitled to such accumulated earnings and profits if divided or distributed, and of the amounts that would be payable to each.

These provisions are substantially the same as provisions contained in the present section 6042.

SECTION 19. REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR (Continued)

(b) *Returns regarding payments of patronage dividends.*—Subsection (b) of the new section 19 amends section 6044 of the 1954 Code, to revise the provisions relating to information returns which must be filed by cooperatives.

Under existing law, a cooperative must file an information return with respect to patronage dividends which it pays to a patron during a calendar year if the aggregate is $100 or more. Existing law also gives the Secretary of the Treasury or his delegate authority to require such information returns with regard to all patronage dividends regardless of amounts. The revised section 6044 requires reporting with respect to all payments of $10 or more during the calendar year and, in addition, reflects the provisions of the new subchapter T of chapter 1 (relating to the tax treatment of cooperatives and patrons) which is added to the code by section 17 of the bill.

SECTION 6044. RETURNS REGARDING PATRONAGE DIVIDENDS

(a) *Requirement of reporting.*—Subsection (a)(1) provides that, except as otherwise provided in section 6044, every cooperative to which part I of subchapter T of chapter 1 applies, which makes payments of amounts described in subsection (b) aggregating $10 or more to any person during any calendar year, is to file an information return with respect to such payments. Such return is to be made according to the forms or regulations prescribed by the Secretary of the Treasury or his delegate and is to set forth the aggregate amount of the payments and the name and address of the person to whom paid.

Subsection (a)(2) provides that the Secretary of the Treasury or his delegate may require information returns regarding payments of amounts described in subsection (b) where such payments aggregate less than $10 to any person during any calendar year.

(b) *Amounts subject to reporting.*—Subsection (b)(1) provides that the amounts with respect to which reporting is required by subsection (a) are (except as otherwise provided by sec. 6044): (A) Patronage dividends paid in cash, qualified written notices of allocation, or other property (except nonqualified written notices of allocation); (B) in the case of an exempt farmers' cooperative, amounts described in section 1382(c)(2)(A) (relating to amounts paid with respect to nonpatronage earnings) which are paid in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation); (C) amounts described in section 1382(b)(2) paid in redemption of nonqualified written notices of allocation which were previously paid as patronage dividends; and (D) amounts described in section 1382(c)(2)(B) paid by an exempt farmers' cooperative in redemption of nonqualified written notices of allocation previously paid with respect to nonpatronage earnings. The cooperative is required to report these amounts even though it must pay tax with respect to them because they were not paid within the prescribed time limits.

Subsection (b)(2) provides that information reporting shall not be required, to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, with respect to any payment (A) by a foreign corporation, or (B) to a foreign corporation, a nonresident alien, or a partnership not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens.

(c) *Exemption for certain consumer cooperatives.*—Subsection (c) of the new section 6044 provides that a cooperative which the Secretary of the Treasury 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 is to be granted exemption from the requirements of information reporting imposed by subsection (a) upon application for such exemption to the Secretary of the Treasury or his delegate. The application for exemption is to be made in accordance with regulations prescribed by the Secretary of the Treasury or his delegate.

(d) *Determination of amount paid.*—Subsection (d) provides that for purposes of section 6044, in determining the amount of any payment, property (other than a written notice of allocation) is to be taken into account at its fair market value, and a qualified written notice of allocation is to be taken into account at its stated dollar amount.

(e) *Statements to be furnished to persons with respect to whom information is furnished.*—Subsection (e) provides that every cooperative making a return under subsection (a)(1) shall furnish to each person whose name is set forth in such return a written statement showing (1) the name and address of the cooperative making the return, and (2) the aggregate amount of payments to the person as shown on the return. This written statement is to be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a)(1) was made. However, no statement is required to be furnished to any person under this subsection if the aggregate amount of payments to the person as shown on the return made under subsection (a)(1) is less than $10.

SECTION 19. REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR (Continued)

(c) *Returns regarding payments of interest.*—Subsection (c) of the new section 19 amends subpart B of part III of subchapter A of chapter 61 of the code (relating to information concerning transactions with other persons) by adding a new section 6048 to such subpart B.

SECTION 6048. RETURNS REGARDING PAYMENTS OF INTEREST

(a) *Requirement of reporting.*—Paragraph (1) of new section 6048(a) requires every person making payments of interest (as defined in subsec. (b)) aggregating $10 or more to any other person during any calendar year to report such payments. In addition, paragraph (1) requires persons receiving payments of interest (as defined in subsec. (b)) in the capacity of nominee to report payments by them aggregating $10 or more during any calendar year to any other person with respect to such interest so received. The return to be filed under paragraph (1) is to be made according to the forms or regulations prescribed by the Secretary of the Treasury or his delegate and is to set forth the name and address of the person to whom the payments were made and the aggregate amount of such payments.

Paragraphs (2) and (3) restate, in general, provisions of existing law (sec. 6041(c)). Paragraph (2) provides that, when required by the Secretary of the Treasury or his delegate, every person who makes payments of interest (as defined in subsec. (b)) aggregating less than $10 to any other person during any calendar year is to make a return setting forth the aggregate amount of such payments and the name and address of the person to whom paid. Under existing law the Secretary of the Treasury or his delegate has discretionary authority to require every corporation making payments of interest, regardless of amounts, to report the amounts so paid. Paragraph (2) limits the discretionary authority of the Secretary of the Treasury or his delegate to require information returns, with respect to payments of interest defined in subsection (b), to such payments to another person aggregating less than $10 during a calendar year. Payments aggregating $10 or more during the year must be reported under subsection (a)(1).

Paragraph (3) provides that, when required by the Secretary of the Treasury or his delegate, every corporation making payments, regardless of amounts, of interest other than interest as defined in subsection (b), is to make a return according to the forms or regulations prescribed by the Secretary of the Treasury or his delegate, setting forth the amount paid and the name and address of the recipient of each such payment.

(b) *Interest defined.*—Subsection (b)(1) of the new section 6048 defines the term "interest" for purposes of subsections (a) (1) and (2) of such section to mean:

(A) Interest on evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a corporation in registered form, and to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, interest on other evidences of indebtedness issued by a corporation of a type offered by corporations to the public. For this purpose, an instrument is in registered form if its transfer must be effected by the surrender of the old instrument and either the reissuance of the old instrument by the corporation to the new holder or the issuance by the corporation of a new instrument to the new holder. If an instrument can be transferred by endorsement it is not in registered form even though a list is maintained by the corporation of such instruments issued by it.

As used in subsection (b)(1) the term "of a type offered by corporations to the public" refers to a type of instrument. In determining whether a particular instrument comes within the scope of the term it is immaterial whether the particular instrument (or any instrument of the issue of which it is a part) actually was offered to the public so long as it is of a type which is offered by corporations to the public. Therefore, in a case where an entire issue is offered by a corporation only to its shareholders, the instruments come within the scope of the term if they are of a type offered by corporations to the public. The term does not have reference to instruments of a type offered by corporations only to other corporations. Coupon bonds issued by a corporation are an example of an evidence of indebtedness with respect to which the Secretary of the Treasury or his delegate may require information reporting under subsections (a) (1) and (2).

(B) Interest on deposits with persons carrying on the banking business. This includes interest paid or credited by any individual or organization carrying on the banking business.

(C) Amounts (whether or not designated as interest) paid or credited 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. This includes interest paid with respect to face amount certificates.

(D) Interest on amounts held by an insurance company under an agreement to pay interest thereon. This subparagraph includes interest paid with respect to policy dividends held by an insurance company, and interest on the proceeds of an insurance policy held by an insurer under an agreement to pay interest thereon. This paragraph does not apply to amounts which represent the so-called "interest element" in the case of annuity or installment payments under a life insurance or endowment contract.

(E) Interest on deposits with stockbrokers and dealers in securities. This subparagraph includes interest on deposits with stockbrokers, bondbrokers, and other persons engaged in the business of dealing in securities.

Subsection (b)(2) provides that, for purposes of subsection (a) (1) and (2), the term "interest" does not include:

(A) Interest on obligations described in section 103(a) (1) or (3) of the code (relating to obligations of a State, etc.);

(B) To the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, any amount paid by or to a foreign corporation, a nonresident alien, or a partnership not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens; and

(C) Any amount on which the person making payment 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 1451(d) (relating to benefit of personal exemptions). Thus, the payment of interest on a tax-free covenant bond issued before January 1, 1934, is not required to be reported under subsection (a) (1) and (2). The fact that the person entitled to receive such interest files with the payer a signed notice in writing, as provided in section 1451(d) of the 1954 Code, claiming benefit of the deduction for personal exemptions provided in section 151 of the code, thereby relieving the payer of the duty to withhold a tax under section 1451(a), does not abrogate the exception provided by this subparagraph.

(c) *Statements to be furnished to persons with respect to whom information is furnished.*—Subsection (c) of the new section 6042 requires every person making a return under subsection (a)(1) to furnish to each person whose name is set forth in such return a written statement showing (1) the name and address of the person making the return, and (2) the aggregate amount paid to the person as shown on the return. Such written statement is to be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a)(1) was made. However, no statement is required to be furnished to any person under this subsection if the aggregate amount of payments to the person as shown on the return made under subsection (a)(1) is less than $10.

SECTION 19. REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR (Continued)

(d) *Penalties for failure to file information returns.*—Subsection (d) of section 19 of the bill amends section 6652 of the 1954 Code (relating to failure to file information returns) to provide a new civil penalty for failure to file an information return with respect to payments aggregating $10 or more, respectively, of dividends, interest, or patronage dividends as required by the amendments made to the code by subsections (a), (b), and (c) of the new section 19, and to reflect the other amendments with respect to information reporting made by such subsections.

SECTION 6652. FAILURE TO FILE CERTAIN INFORMATION RETURNS

(a) *Returns relating to payments of dividends, interest, and patronage dividends.*—Subsection (a) provides a new penalty of $10 per statement for each failure to file a statement of the aggregate amount of payments to another person, as required by section 6042(a)(1) (relating to payments of dividends aggregating $10 or more), section 6044(a)(1) (relating to payments of patronage dividends aggregating $10 or more), or section 6048(a)(1) (relating to payments of interest aggregating $10 or more), on the date prescribed therefor (determined with regard to any extension of time for filing). No penalty is to be imposed, however, with respect to a failure to file a statement, if it is shown by the payer that the failure was due to reasonable cause and not to willful neglect. The penalty is to be paid, upon notice and demand by the Secretary of the Treasury or his delegate and in the same manner as tax, by the person failing to so file the statement. The total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed $25,000.

(b) *Other returns.*—Subsection (b) retains the penalty provided under existing section 6652 for failures to file information returns not covered by the new $10 penalty in subsection (a). Subsection (b) provides a penalty of $1 for each failure to file a statement, at the proper time, of a payment to another person required under authority of section 6041 (relating to certain information at source), section 6042(a)(2) (relating to payments of dividends aggregating less than $10), section 6044(a)(2) (relating to payments of patronage dividends aggregating less than $10), section 6048(a)(2) (relating to payments of interest aggregating less than $10), section 6048(a)(3) (relating to other payments of interest by corporations), or section 6051(d) (relating to information returns with respect to income tax withheld). The penalty is to be imposed, with respect to each failure, unless it is shown that the failure was due to reasonable cause and not to willful neglect. The penalty is to be paid, upon notice and demand by the Secretary of the Treasury or his delegate and in the same manner as tax, by the person failing to so file the statement. The total amount imposed on the delinquent person for all such failures during the calendar year shall not exceed $1,000.

SECTION 19. REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR (Continued)

(e) *Penalty for failure to furnish statements to persons with respect to whom returns are filed.*—Subsection (e) of the new section 19 amends subchapter B of chapter 68 (relating to assessable penalties) by adding to such subchapter a new section 6678 to provide civil penalties for failure to furnish statements to persons to whom dividends, patronage dividends, or interest are paid as required by the amendments made to the code by subsections (a), (b), and (c) of the new section 19.

SECTION 6678. FAILURE TO FURNISH CERTAIN STATEMENTS

Section 6678 provides a penalty of $10 for each failure to furnish a statement under section 6042(c), 6044(e), or 6048(c) on the date prescribed therefor to a person with respect to whom an information return has been made under section 6042(a)(1), 6044(a)(1), or 6048(a)(1), respectively. The penalty is to be imposed unless it is shown that such failure was due to reasonable cause and not to willful neglect. The penalty is to be paid, upon notice and demand by the Secretary of the Treasury or his delegate and in the same manner as tax, by the person failing to so furnish the statement. The total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed $25,000.

(f) *Technical amendments.*—Subsection (f) of the new section 19 amends section 6041 of the code, relating to information at source, to reflect the amendments made to the code by subsections (a), (b), and (c) of the new section 19.

Paragraph (1) amends section 6041(a) of the code (relating to information returns with respect to payments of $600 or more) in order to exclude from the application of such section payments of dividends, patronage dividends, and interest aggregating, respectively, $10 or more during any calendar year to another person, and to exclude from such application other payments of dividends, patronage dividends, and interest with respect to which the Secretary of the Treasury or his delegate requires information returns under the authority of sections 6042(a)(2), 6044(a)(2), 6045, 6048(a)(2), and 6048(a)(3) as amended, or added to the code, by your committee's amendment.

Paragraph (2) further amends section 6041 of the code by striking out subsection (c) thereof (relating to payments of interest by corporations) since the provisions of such subsection are contained in the new section 6048 added to the code by subsection (c) of section 19 of the bill.

(g) *Clerical amendments.*—Subsection (g) of section 19 of the bill bill makes certain clerical amendments to the code to reflect the other amendments made to such code by section 19 of the bill.

(h) *Effective date.*—Subsection (h) of section 19 of the bill provides effective dates for the application of the provisions of such section 19 with respect to payments of dividends, interest, and patronage dividends.

Paragraph (1) provides that, except as provided in paragraph (2), the provisions of section 19 of the bill are to apply with respect to payments of dividends and interest on or after January 1, 1963.

Paragraph (2) provides that the provisions of section 19 of the bill are to apply with respect to payments of amounts described in section 6044(b) of the code (relating to returns regarding patronage dividends) 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.

SECTION 20. INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

This section is the same as section 20 of the bill as passed by the House except for certain changes in the constructive ownership rules and in the penalty provision under section 6038 of the code, as amended by the bill (relating to information to be furnished with respect to certain foreign corporations), and except for certain changes in section

6046 of the code, as amended by the bill (relating to information as to the organization or reorganization of foreign corporations and as to acquisitions of their stock). The changes in section 6046 are, in general, as follows: (1) Officers or directors need not file returns unless there are one or more U.S. persons owning 5 percent or more in value of the stock of their foreign corporation; (2) the information required of officers and directors is limited to the names and addresses of U.S. persons who are 5 percent or more shareholders; and (3) information need not be furnished unless such information was required under regulations in effect 90 days prior to the date on which a person becomes liable to file a return.

(a) *Information to be furnished by individuals, domestic corporations, etc., with respect to certain foreign corporations.*—Subsection (a) of section 20 of the bill amends section 6038 of the 1954 Code. Section 6038(a)(1) requires every U.S. person to furnish the information required by such section with respect to any foreign corporation which such person controls (as defined in sec. 6038(d), as amended by the bill). Under existing law, the obligation to furnish information is imposed only on domestic corporations and only with respect to controlled foreign corporations and foreign subsidiaries of such controlled foreign corporations.

The requirements as to the information to be furnished are not changed except that (1) because of the redefinition of "control" including the addition of most of the constructive ownership rules of section 318(a) of the 1954 Code, there will be an increase in the number of persons whose transactions with controlled corporations must be reported, and (2) the Secretary of the Treasury or his delegate is authorized to require the furnishing of any other information which is similar or related in nature to that specified in paragraph (1) of section 6038(a) as amended by the bill.

Under the amendment made by section 20(a) of the bill, the period for which information is to be furnished under section 6038(a)(2) is modified to provide that, in all cases, such period is that ending with or within the U.S. person's taxable year. The amendment does not change the period with respect to a first-tier foreign corporation. However, with respect to a foreign subsidiary of such corporation, the period is changed from that ending with or within the first-tier corporation's annual accounting period to that ending with or within the U.S. person's taxable year. Thus, the effect of the amendment will be to obtain information which is more current from the subsubsidiary.

Section 6038(a)(3), as amended by the bill, is the same as existing law. It provides that no information will be required to be furnished under section 6038(a) 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.

Section 6038(b), which sets forth the penalty for failure to file the required information within the prescribed time, is amended to provide that the reduction in foreign taxes paid or deemed paid now provided by section 6038(b) will occur in applying section 901 as well as section 902, although it will not occur under both sections with respect to the same tax. In addition, the reduction is to apply in respect of taxes deemed paid under section 960 of the code (added by sec. 12(a) of the bill). Also, the penalty provided by section 6038(b), as amended by the bill, is extended to other than corporate taxpayers. Your committee has added a limitation on the penalty provided by section 6038(b) to the effect that the amount of the reduction in foreign tax credit under section 6038(b)(1) for each failure to furnish information with respect to a foreign corporation required under section 6038(a)(1) will not exceed the greater of (1) $10,000, or (2) the income of the foreign corporation for its annual accounting period with respect to which the failure occurs.

The reduction in foreign taxes paid or deemed paid for failure to file the required information within the prescribed time is not to apply, however, in computing accumulated profits in excess of income, war profits, and excess profits taxes under section 902 (a) and (b) of the code (relating to foreign tax credit for a corporate stockholder of a foreign corporation) or under section 960(a) of the code (added by sec. 12(a) of the bill).

Section 6038(c), as amended by the bill, provides that where two or more persons are required to furnish information with respect to the same controlled foreign corporation for the same period, the Secretary of the Treasury or his delegate may prescribe that such information will be required only from one person. To the extent practicable, the Secretary's determination is to be based on actual ownership of stock (as distinguished from constructive ownership).

Section 6038(d) defines "control" as the possession of more than 50 percent of the combined voting power, or of the value, of all classes of stock. A person in control of a corporation which, in turn, owns more than 50 percent of the combined voting power, or of the value, of all classes of stock of another corporation is also treated as in control of such other corporation. Thus, for example, in the case of a chain of corporations consisting of corporation M, owning 51 percent of the voting stock in corporation N, owning, in turn, 51 percent of the voting stock in corporation O, owning, in turn, 51 percent of the voting stock in corporation P; corporation P is controlled by corporation M. The bill as passed by the House provided that the rules of section 318(a) apply in determining stock ownership, except that the rule which requires ownership of 50 percent of the stock of a corporation before stock owned by such corporation is attributed to its stockholders applies without regard to the 50-percent limitation. The constructive ownership rules apply in determining control of domestic and foreign corporations but not in determining, under section 6038(a)(1)(D)(iii), whether a transaction is with a corporation 10 percent or more of the value of any class of stock of which is owned by a U.S. person.

With respect to their application under section 6038, the bill, as amended by your committee, makes the following changes in the rules of section 318(a) as modified by the bill as passed by the House:

(1) The rules that stock owned by or for a partner or a beneficiary of an estate or trust shall be considered as owned by the partnership, estate, or trust will not be applied so as to consider a U.S. person as owning stock owned by a person who is not a U.S. person, nor will a corporation be considered as owning stock owned by or for a 50 percent or more shareholder where the effect is to consider a U.S. person as owning stock which is owned by a person who is not a U.S. person.

(2) The rule that requires ownership of 50 percent (the bill as passed by the House removed this limitation) of the stock of a corporation before stock owned by such corporation is attributed to its stockholders has been modified by substituting the phrase "10 percent" for the phrase "50 percent."

(3) The rule that attributes to a corporation stock owned by or for persons owning the stock of such corporation will not apply.

The amended section 6038(d) defines the "annual accounting period" of a foreign corporation as the annual period on the basis of which such corporation regularly computes its income in keeping its books.

Section 6038(e) provides cross-references to sections 7203 and 7701(a)(30), respectively, for provisions relating to penalties for violations of section 6038, and for the definition of the term "U.S. person."

(b) *Information as to organization or reorganization of foreign corporations and as to acquisitions of their stock.*—Subsection (b) of section 20 of the bill amends section 6046 of the 1954 Code.

Paragraph (1) of section 6046(a), as amended by the bill as passed by the House, required an information return from each U.S. citizen or resident who, on January 1, 1963, was an officer or director of a foreign corporation or who became such an officer or director at any time after that date. In lieu of this provision, the bill, as amended by your committee, requires an information return from each U.S. citizen or resident who is on January 1, 1963, an officer or director of a foreign corporation, 5 percent or more in value of the stock of which is owned by a U.S. person, or who becomes such an officer or director at any time after such date.

Paragraph (2) of section 6046(a) requires each U.S. person to file an information return under any of the following circumstances:

(1) He owns 5 percent or more in value of the stock of a foreign corporation on January 1, 1963.

(2) He owns stock of a foreign corporation on January 1, 1963, which has a value of less than 5 percent of the value of the stock of such corporation, or owns no stock on January 1, 1963, and thereafter acquires stock which, when added to the stock held on January 1, 1963, if any, has a value equal to 5 percent or more of the value of the stock of such foreign corporation.

(3) He acquires an additional 5 percent or more in value of the stock of a foreign corporation.

Paragraph (3) of section 6046(a) requires each person who becomes a U.S. person after January 1, 1963, while owning 5 percent or more in value of the stock of a foreign corporation to file an information return.

Example.—A, a U.S. person, who on January 1, 1963, owns 2 percent in value of the stock of foreign corporation M, is not required to file an information return under section 6046. However, when he acquires, on April 1, 1963, an additional block of stock consisting of 4 percent in value of the stock of such corporation, he is required by subparagraph (A) of section 6046(a)(2) to make an information return with respect to corporation M. If, on December 31, 1964, he acquires a 6-percent block of stock in addition to that already owned, he is required to file a return under subparagraph (B) of section 6046(a)(2). He is not required to report when, on May 1, 1965, he acquires an additional 3-percent block of stock, but he is required to report under subparagraph (B) when, on November 30, 1965, he acquires a 4-percent block of stock because the last two blocks of stock total more than 5 percent.

Subsection (b) of section 6046, as amended by the bill as passed by the House, was the same as existing law. It provided that the information returns required by subsection (a) of section 6046 shall be in such form and shall set forth, in respect of the foreign corporation, such information as the Secretary of the Treasury or his delegate prescribes by forms or regulations as necessary for carrying out the provisions of the income tax laws. Your committee has added a provision which limits the information which may be required of persons described in subsection (a)(1) to the names and addresses of persons described in subsection (a)(2).

Subsection (c) of section 6046 is amended by omitting the definition of "U.S. shareholder". The term "U.S. person", as used in sections 6038 and 6046, as amended by the bill, has the same substantive meaning as the term "U.S. shareholder" in existing section 6046.

Subsection (d) of section 6046, as amended by the bill, provides a limitation on the time for filing a return required by subsection (a) of such section. Such return must be filed on or before the 90th day after the day on which, under any provision of section 6046(a), the U.S. citizen, resident, or person becomes liable to file such return.

Your committee has redesignated subsection (e) of section 6046 (as amended by the bill as passed by the House) as subsection (f) and added a new subsection (e) which provides that no information shall be required to be furnished under section 6046 with respect to any foreign corporation, if the liability of the U.S. citizen, resident, or person to file a return under subsection (a) arises on or after January 1, 1963, and before March 1, 1963, unless such information was required to be furnished under regulations which have been in effect since January 1, 1963 (but only if such regulations were prescribed before December 1, 1962); or, if the liability of the U.S. citizen, resident, or person to file a return under subsection (a) arises on or after March 1, 1963, unless such information was required to be furnished under regulations which have been in effect for at least 90 days.

Subsection (f) of section 6046, as amended by the bill, is a cross-reference to section 7203, relating to willful failure to file a return, supply information, or pay tax.

(c) *Civil penalty for failure to file return.*—Subsection (c) of section 20 of the bill amends subchapter B of chapter 68 (relating to assessable penalties) by adding new section 6679.

Subsection (a) of section 6679, similar in purpose to section 6677 (relating to failure to file information returns with respect to certain foreign trusts) as added by section 7(g) of the bill, provides that 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 section 6046, or who files a return which does not show the information required pursuant to such section, must pay a penalty of $1,000, unless it is shown that such failure is due to reasonable cause.

Subsection (b) of section 6679 provides that subchapter B of chapter 63 (relating to deficiency procedure for income, estate, and gift taxes) is inapplicable in respect of the assessment or collection of any penalty imposed by subsection (a).

(d) *Technical amendments.*—Subsection (d) of section 20 of the bill contains technical amendments adding a cross-reference to section 318 of the code and conforming the appropriate table of sections to the change in the heading of section 6046.

(e) *Effective date.*—Under subsection (e) of section 20 of the bill, section 6038 of the code as amended by the bill is to apply with respect to annual accounting periods of foreign corporations beginning after December 31, 1962, and section 6046 of the code as amended by the bill is to take effect on January 1, 1963. Under subsection (e)(1), existing section 6038 will continue to apply in respect of a foreign corporation or foreign subsidiary whose annual accounting period begins before January 1, 1963. For example, assume that D, a domestic corporation, has a taxable year beginning July 1, 1963, and ending June 30, 1964. F, a foreign corporation controlled by D, has an annual accounting period beginning January 1, 1963, and ending December 31, 1963. FS, a foreign subsidiary of F, has an annual accounting period beginning April 1, 1962, and ending March 31, 1963. Under the effective date provision, information with respect to FS's annual accounting period beginning April 1, 1962, and ending March 31, 1963, is to be furnished under existing law, and information with respect to F's annual accounting period beginning January 1, 1963, and ending December 31, 1963, is to be furnished under section 6038 as amended by the bill.

SECTION 21. EXPENDITURES BY FARMERS FOR CLEARING LAND

Section 21 of the bill, which is a new section added to the bill as passed by the House, amends the Internal Revenue Code of 1954 by adding a new section 182, relating to the tax treatment of expenditures by farmers for clearing land.

Subsection (a) of section 182 permits farmers to elect to treat as deductible expenses, rather than as nondeductible improvements to property, expenditures for clearing land if such expenditures are for the purpose of making the land suitable for use in farming.

Subsection (b) of section 182 limits the deduction under subsection (a) for any taxable year to $5,000, or to 25 percent of the taxable income derived from farming during the taxable year, whichever amount is the lesser. For purposes of such 25-percent limitation, the term "taxable income derived from farming" means the gross income of the taxpayer derived from farming during the taxable year, that is, the gross income of the taxpayer from the production of crops, fruits, or other agricultural products or from livestock, reduced by the allowable deductions which are attributable to the business of farming other than the deduction allowed by section 182. Thus, all of the ordinary and necessary expenses paid or incurred in the business of farming, including amounts allowed as deductions by sections 175 and 180 for soil and water conservation expenditures and for lime and fertilizer expenditures, respectively, but not including the amount allowed as a deduction by section 182 for expenditures for clearing land, should be deducted from gross income derived from farming in computing the taxable income derived from farming for purposes of applying the 25-percent limitation on the amount deductible as an expenditure for clearing farm land.

The term "clearing of land" is defined in subsection (c)(1) of section 182 to include, but is not limited to, the eradication of trees, stumps, and brush, the treatment or moving of earth, and the diversion of streams and watercourses. Your committee's amendment has application only in respect of expenditures paid or incurred in the clearing of land for the purpose of making such land suitable for use in farming. The term "land suitable for use in farming" means land which as a result of the clearing of land, as described above, is suitable for use by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.

Subsection (d)(1) of section 182 provides that the expenditures to which section 182(a) applies do not include expenditures for the purchase, construction, installation, or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation. In addition, such expenditures do not include any expense which is deductible under any other section of the code.

Subsection (d)(2) of section 182 provides that expenditures to which section 182(a) applies shall include a reasonable allowance for depreciation with respect to property which is used in the clearing of land for the purpose of making such land suitable for use in farming and which if used in a trade or business, would be property subject to the allowance for depreciation. Under present law such depreciation must be capitalized. Such subsection (d)(2) further provides that to the extent an amount representing a reasonable allowance for depreciation with respect to property used in clearing land is treated as an expenditure to which subsection (a) applies, such expenditure shall, for purposes of chapter 1 of the 1954 Code, be treated as amount allowed under section 167 for depreciation of such property. Under this provision, proper adjustment to the basis of such property would be made under section 1016(a) of the 1954 Code.

Subsection (e) of section 182 provides that the taxpayer shall make the election to deduct his expenditures for clearing his land within the time prescribed by law (including extensions thereof) for filing his return for any taxable year in which he pays or incurs such expenditures, and that such election shall be made in such manner as the Secretary of the Treasury or his delegate may by regulations prescribe. Once the election is made for any taxable year such election may not be revoked without the consent of the Secretary of the Treasury or his delegate.

SECTION 22. CHARITABLE CONTRIBUTIONS MADE FROM INCOME ATTRIBUTABLE TO SEVERAL TAXABLE YEARS

Section 22 of the bill, which is a new section added to the bill as passed by the House, amends section 1307 of the Internal Revenue Code of 1954 by adding a new subsection (e) thereto. Section 1307 relates to rules applicable to part I of subchapter Q of such code which part relates to income attributable to several taxable years.

Part I of subchapter Q provides a limitation with respect to the tax imposed on certain amounts received or accrued by an individual taxpayer during a taxable year. The tax attributable to any such amount for the taxable year in which it is received or accrued is, in general, not to be greater than the aggregate increases in taxes which would have resulted if the amount had been included in the taxpayer's income, on an allocated basis, over the period specified in the applicable section of such part I.

It is the present position of the Internal Revenue Service that in computing tax in accordance with part I of subchapter Q the adjusted gross income for the taxable year in which the amount was received or accrued shall be computed without regard to that portion of such amount which is allocated to other taxable years. (See, Internal Revenue Mimeograph 43, 1952-2 C.B. 112.) The amounts allowable as deductions under section 170, relating to charitable, etc., contributions and gifts, and under section 213, relating to medical, dental, etc., expenses, are based upon percentages of adjusted gross income. The computation of adjusted gross income without including that portion of the amount received or accrued which is allocated to other taxable years results in a determination of adjusted gross income which is less than would be the case if adjusted gross income for the taxable year in which the amount was received or accrued were computed without regard to part I of subchapter Q. A lower adjusted gross income figure for the taxable year decreases the allowable deduction for charitable contributions and increases the allowable medical deduction.

New subsection (e) provides that an individual who receives or accrues in a taxable year an amount to which part I of subchapter Q applies may elect (in such manner and at such time as the Secretary of the Treasury or his delegate prescribes by regulations) to apply the provisions of subsection (e) in computing his tax liability under such part. If the taxpayer so elects, the amount received or accrued shall be reduced, for the purposes of computing his tax liability under such part I with respect to such amount, by an amount (1) which bears the same ratio to the amount of his allowable charitable deduction for the taxable year in which the amount was received or accrued (computed without regard to pt. I of subch. Q) as (2) the amount received or accrued during the taxable year to which part I applies bears to the adjusted gross income for such year (computed without regard to pt. I of subch. Q).

The last sentence of new subsection (e) provides that no portion of the amount received or accrued to which part I of subchapter Q applies shall (for purposes of computing the limitation on tax under such part) be taken into account for purposes of computing the limitation under section 170(b)(1) of the code for the taxable year in which the amount to which such part applies is received or accrued.

Example.—Assume the following facts with respect to individual I (who elects to have the new subsection (e) apply) for the taxable year 1963:

(1) Amount received or accrued to which pt. I of subch. Q applies	$12,000
(2) Adjusted gross income (determined without regard to pt. I of subch. Q)	16,000
(3) Deductible charitable contributions (determined without regard to pt. I of subch. Q)	1,600

Assume further that, for purposes of computing the limitation on tax under part I of subchapter Q, the $12,000 amount is to be prorated in equal amounts to the taxable years 1960, 1961, 1962, and 1963.

Under the first sentence of the new subsection (e), for purposes of computing the tax liability of the taxpayer under part I, the $12,000 is reduced by $1,200 (that portion of the $1,600 deductible charitable contributions which $12,000 is of $16,000). The remainder, $10,800, is then prorated at the rate of $2,700 per year to 1960, 1961, 1962, and 1963.

Under the last sentence of the new subsection (e), for purposes of computing the limitation on tax under part I, the $12,000 amount is not to be taken into account for 1963 for purposes of computing the limitation under section 170(b)(1) on the amount deductible for charitable contributions during 1963. Thus, for this purpose, the adjusted gross income is to be treated as being $4,000 (the amount remaining after excluding $12,000 from $16,000).

SECTION 23. EFFECTIVE DATE OF SECTION 1371(c) OF THE INTERNAL REVENUE CODE OF 1954

Section 23 of the bill, which is a new section added to the bill as passed by the House, relates to the effective date of section 1371(c) of the Internal Revenue Code of 1954.

(a) *In general.*—Subsection (a) of section 23 of the bill provides that section 1371(c) of the code, which was added by section 2(a) of the Act of September 23, 1959 (Public Law 86–376), shall (notwithstanding the provisions of the first sentence of sec. 2(d) of such Act) also apply to taxable years beginning after December 31, 1957, and before January 1, 1960. Section 1371(c) provides that stock which is community property of a husband and wife (or the income from which is community income) under the applicable community property law of a State, or is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common, shall be treated as owned by one shareholder. The first sentence of section 2(d) of Public Law 86–376 provides that section 1371(c) is to apply to taxable years beginning after December 31, 1959. Under your committee amendment, if the provisions of subsections (b) and (c) of section 23 of the bill are met, section 1371(c) will now be applicable for all taxable years for which a corporation may elect to be taxed as an electing small business corporation under subchapter S (secs. 1371–1377) of the code.

The enactment of this new effective date for section 1371(c) does not relax or otherwise change the requirements of any of the provisions of subchapter S. Thus, in order to be eligible to be treated as an electing small business corporation for years beginning after December 31, 1957, and before January 1, 1960, a "small business corporation" must have filed a timely election for such year in accordance with section 1372 and in the manner prescribed by the Secretary of the Treasury or his delegate by regulations. Such election must have been valid in all respects except that by reason of counting a husband and wife owning stock of a corporation in the specified joint forms or as community property as two shareholders, the corporation failed to meet the requirement that a small business corporation must have 10 or fewer shareholders. Furthermore, shareholder consents to such elections must have been filed in the prescribed time and manner. However, the Commissioner has announced that he will consider, upon request, the granting of extensions of time for the filing of consents in certain cases under section 1.9100–1 of the Income Tax Regulations.

If all the requirements, except the 10-or-fewer-shareholder requirement, had been met for taxable years beginning after December 31, 1957, and before January 1, 1960, and the effect of applying the new effective date of section 1371(c) is to reduce the number of shareholders to 10 or fewer, the election shall be treated as a valid election, and the corporation shall be treated as an electing small business corporation for the year of the election and all succeeding years (unless, even though sec. 1371(c) is applicable, the election has been terminated for any reason) if the corporation and the shareholders meet the requirements of subsections (b) and (c) of section 23 of the bill. The earlier effective date provided in subsection (a) is also available in those situations where the initial election was valid, but where a termination in a subsequent taxable year beginning before January 1, 1960, is attributable solely to the fact that, by counting a husband and wife owning stock in joint form or as community property as two shareholders, the corporation had more than 10 shareholders and thus failed to meet the definition of a small business corporation. In such a case, if the corporation and shareholders elect and consent as provided in subsections (b) and (c) of section 23 of the bill, such termination shall be disregarded, and such corporation shall be treated as an electing small business corporation for the year of the termination and all succeeding years (unless, even though sec. 1371(c) is applicable, the election has been terminated for any reason).

(b) *Election and consent by corporations; consent by shareholders.*—Subsection (b) of section 23 of the bill prescribes rules which must be complied with if the earlier effective date provided in subsection (a) is to apply with respect to any electing small business corporation and its shareholders.

Subsection (b)(1) provides that the earlier effective date for section 1371(c) shall not apply unless the corporation elects, within 1 year after the date of the enactment of the bill, to have the earlier effective date apply and consents to the application of subsection (c) (relating to tolling of statutes of limitations). Both the election to have the provisions of subsection (a) apply and the consent to the application of subsection (c) are to be made in such manner as the Secretary of the Treasury or his delegate prescribes by regulations.

Under subsection (b)(2), each shareholder of the corporation must consent to the corporation's election, and must also consent to the application of subsection (c), within 1 year after the date of the enactment of the bill. These consents, which must be filed in such manner and at such time as the Secretary of the Treasury or his delegate prescribes by regulations, are required of each person who is a shareholder of the corporation on the date the corporation makes the election under subsection (b)(1), and of each person who was a shareholder of the corporation at any time during any taxable year of the corporation beginning after December 31, 1957, and ending before the date of such election. It is contemplated that the election and consent by the corporation under subsection (b)(1) and the consents by its shareholders under subsection (b)(2) will be filed together.

(c) *Tolling of statutes of limitations.*—Subsection (c) of section 23 of the bill provides for a tolling of the statutes of limitations with respect to (1) the assessment of deficiencies, and (2) the credit or refund of overpayments, which are attributable to the application of the earlier effective date provided in subsection (a).

Subsection (c)(1) provides that if the assessment of any deficiency against the corporation making such election, or against any shareholder of such corporation who consents to such election, for any taxable year is prevented, at any time on or before the expiration of 1 year after the date of such election, by the operation of any law or rule of law, assessment of such deficiency may, nevertheless, be made, to the extent such deficiency is attributable to the application of subsection (a), at any time on or before the expiration of such 1-year period.

Subsection (c)(2) provides that if credit or refund of any overpayment of tax by the corporation making such election, or by any shareholder of such corporation who consents to such election, for any taxable year is prevented, at any time on or before the expiration of 1 year after the date of such election, by the operation of any law or rule of law, credit or refund of such overpayment may, nevertheless, be allowed or made, to the extent such overpayment is attributable to the application of subsection (a), if claim therefor is filed on or before the expiration of such 1-year period.

SECTION 24. CERTAIN LOSSES SUSTAINED IN CONVERTING FROM STREET RAILWAY TO BUS OPERATIONS

Section 24 of the bill, which is a new section added to the bill as passed by the House, relates to certain losses sustained in converting from street railway to bus operations.

(a) *In general.*—Subsection (a) of section 24 of the bill provides that if a corporation has a net operating loss for the taxable year ending December 31, 1953, or the taxable year ending December 31, 1954, principally as the result of conversion from street railway to bus operations with respect to part or all of the company's operations, then its unused conversion loss (as defined in subsec. (b)) will be subject to the treatment provided in subsection (c).

(b) *Unused conversion loss defined.*—Subsection (b) of section 24 of the bill defines an "unused conversion loss" as the aggregate of the net operating losses for the taxable years ending December 31, 1953 and 1954, reduced to the extent that they have been used as net operating loss carryovers or carrybacks to reduce taxable income for any taxable year beginning before January 1, 1960.

(c) *Treatment of unused conversion loss.*—Subsection (c) of section 24 of the bill provides that if a taxpayer has an unused conversion loss, it shall be treated by such taxpayer as a net operating loss for the taxable year ending December 31, 1959, in determining the amount of the net operating loss carryover from such taxable year to each of the 5 taxable years following such taxable year. Subsection (c) applies, however, only for years in which the taxpayer is engaged in the furnishing or sale of transportation (as defined in sec. 1503(c)(1)(A) of the 1954 Code).

(d) *Regulations.*—Subsection (d) of section 24 of the bill authorizes the Secretary of the Treasury or his delegate to prescribe by regulation such rules as may be necessary to carry out the purposes of this section.

SECTION 25. PENSION PLAN OF LOCAL UNION NO. 435, INTERNATIONAL HOD CARRIERS' BUILDING AND COMMON LABORERS' UNION OF AMERICA

Section 25 of the bill, which is a new section added to the bill as passed by the House, provides that the pension plan of Local Union No. 435 of the International Hod Carriers' Building and Common Laborers' Union of America, which was negotiated to take effect May 1, 1960, pursuant to an agreement between such union and the Building Trades Employers Association of Rochester, N.Y., shall be held and considered to have been a qualified trust under section 401(a) of the Internal Revenue Code of 1954, and to have been exempt from taxation under section 501(a) of such code, for the period beginning May 1, 1960, and ending April 20, 1961, but only if it is shown to the satisfaction of the Secretary of the Treasury or his delegate that the trust has not in this period been operated in a manner which would jeopardize the interests of its beneficiaries.

SECTION 26. CONTINUATION OF A PARTNERSHIP YEAR FOR SURVIVING PARTNER IN A TWO-MAN PARTNERSHIP WHERE ONE DIES

(a) *Close of taxable year of two-man partnership when one partner dies.*—Paragraph (1) of subsection (a) of section 26 of the bill is a clerical amendment the effect of which is to designate the text of section 188 of the Internal Revenue Code of 1939 as subsection (a) of section 188.

Paragraph (2) of subsection (a) of section 26 of the bill amends section 188 of the Internal Revenue Code of 1939 (relating to different taxable years of partner and partnership) by adding a new subsection (b). The new subsection (b) provides that for purposes of chapter 1 of the 1939 Code, if the surviving partner so elects within 1 year after the date of enactment of this bill, the death of one of the partners of a partnership consisting of two members shall not result in the termination of the partnership or in the closing of the taxable year of the partnership with respect to the surviving partner prior to the time the partnership year would have closed if neither partner had died or disposed of his interest.

(b) *Effective date, etc.*—Subsection (b) of section 26 of the bill provides that the amendments made by section 26 of the bill are to apply with respect to taxable years of a partnership beginning after December 31, 1946, to which the Internal Revenue Code of 1939 applies. Subsection (b) further provides that if refund or credit of any overpayment resulting from the application of the amendment made by new section 188(b) (including interest, additions to the tax, and additional amounts), is prevented on the date of enactment of this bill, or within 1 year from such date, by the operation of any law or rule of law (other than sec. 3760 of the Internal Revenue Code of 1939 or sec. 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than sec. 3761 of the Internal Revenue Code of 1939 or sec. 7122 of the Internal Revenue Code of 1954, relating to compromises), such refund or credit or such overpayment, may, nevertheless, be made or allowed if claim therefor is filed within 1 year after the date of enactment of this bill. Furthermore, no interest shall be allowed or paid on any overpayment resulting from the enactment of this section.

SECTION 27. TREATIES

Section 7852(d) of the 1954 Code provides that no provision of the 1954 Code shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on August 16, 1954. The bill as passed by the House provided that section 7852(d) would not apply in respect of any amendment made by the bill, thus providing that in the event there was any conflict with any treaty provision (whether or not such provision was in effect on August 16, 1954) the provisions of the bill would govern. Your committee has stricken this provision and substituted for it an amendment providing that no provision of the bill shall apply in any case where its application would be contrary to any treaty obligation of the United States.

CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

INDIVIDUAL VIEWS OF SENATORS HARRY F. BYRD, ALBERT GORE, JOHN J. WILLIAMS, AND CARL T. CURTIS ON SECTION 2 OF H.R. 10650

We oppose section 2 of the 1962 revenue bill (H.R. 10650) which would give a 7-percent tax credit to segments of business for investment in new machinery and equipment.

Our opposition to this section of the bill is based on firm convictions after full consideration of views expressed by competent witnesses in exhaustive hearings, and those expressed in voluminous correspondence from the general public.

We have given closest possible study to statements in behalf of the administration's recommendations made before the Senate Finance Committee which, in some respects, are at variance with provisions now in the section.

Before adopting the "investment credit" (sec. 2) provisions as reported, the Senate must consider the fact that the Internal Revenue Service on July 11, 1962, substantially revised its regulations to accelerate regular depreciation.

Our position is in accord with views of a vast number of citizens, including those representing industry, business, labor, and agriculture throughout the Nation, who have testified and counseled for rejection of the provisions of section 2.

Hearings on the pending bill were held over a period of 4 months, and a substantial portion of the testimony taken was directed to section 2. Generally, our conclusions may be summarized, but the detail must be considered, too.

In summary, we oppose "investment credit" as it would be provided by section 2 for numerous reasons including the facts that—

(1) It would be a subsidy in the nature of a windfall to be given to businesses which comply with a Government policy.

(2) It would be discriminatory in its application among various businesses, even among those similar in kind.

(3) Its value and its need as a stimulant to so-called "economic growth" are both questionable and doubtful.

(4) Its continuing cost would be heavy and it would increase the Federal deficit in the current fiscal year.

WOULD INCREASE DEFICIT

There was a Federal deficit of $6.3 billion in fiscal year 1962 which ended June 30. There will be another deficit in the current fiscal year which started July 1. The "investment credit" provisions in H.R. 10650 would increase the 1963 deficit by $630 million (net).

The staff of the Joint Committee on Internal Revenue Taxation, using officially budgeted expenditures, estimates that—

(1) The Federal deficit in the current fiscal year 1963 will be more than $3.9 billion, excluding the effect of this bill.

(2) This Federal deficit would be increased by a total of more than $1 billion if H.R. 10650, as passed by the House of Representatives, were enacted; and

(3) The Federal deficit estimate would have to be increased by a total of $630 million (net) if the bill, as reported by the Senate Finance Committee, were enacted.

If H.R. 10650—in either the House or the Senate committee version—were enacted, a substantial portion of the estimated increase in the Federal deficit would be directly attributable to the effect of the "investment credit" provisions alone. The Joint Committee staff estimates that—

(1) Under the House-passed version of the "investment credit" provisions, revenue in fiscal year 1963 would be reduced by $1.3 billion; and

(2) Under the Senate committee version of the "investment credit" provisions, revenue in fiscal year 1963 would be reduced by $650 million (gross).

If the "investment credit" provisions of section 2 remain in this bill and the measure is enacted, they will become permanent in the law. For this reason it is appropriate for the Senate at this time to examine the long-range budgetary effects.

When this is done, the enormity of the revenue loss becomes even more clear, and the budgetary effect becomes even more significant. Extending application of the "investment credit" provisions over an 11-year period (1962–72), the Joint Committee staff finds that—

(1) Business tax liabilities would be reduced during that period by $21 billion under the House-passed version; and

(2) Business tax liabilities would be reduced during that period by $15.6 billion under the Senate committee version.

Revenue loss resulting from application of the new depreciation guidelines made effective by the Treasury Department on July 11, 1962, would be in addition to revenue loss resulting from the "investment credit" provisions in this bill if they were enacted.

The Treasury has estimated that in their first year of operation the recent revisions in Internal Revenue Service rules on depreciation will result in a reduction in business tax liabilities of $1.5 billion. Estimates for subsequent years have not been made.

WRONG IN PRINCIPLE

The "investment credit" proposed in section 2 of this bill is wrong in principle. It would be discriminatory in its application. It would do harm to our tax structure. It would not achieve so-called "growth" in investment. It is not needed under existing conditions.

Under terms of the bill, those complying with the "investment credit" provisions would be entitled to a tax credit which could be offset directly against income tax liability. Coupled with depreciation, "investment credit" would return to the investor more than he paid for the asset.

It should be made clear for the record and the information of the Senate that the tax "credit" would not be included in taxable income. If a corporate tax rate of about 50 percent were assumed, an "investment credit" of $7 would be equal to $14 of additional income before taxes in the year.

87490—62——23

Under existing law and Internal Revenue Service regulations the cost of *plant*, machinery, and equipment generally may be depreciated 100 percent over specified periods; and depreciation has been accelerated under the new rules now in force.

Under the current administration proposal and House bill provisions "investment credit" for new machinery and equipment would be in addition to 100-percent depreciation. Under the Senate committee version of the bill the "investment credit" would be in addition to 93-percent depreciation.

The administration proposed an 8-percent "investment credit" (with public utilities excluded) on new machinery and equipment in addition to 100-percent depreciation. The effect of this would be to give investors generally 116 percent of what they paid for the asset.

The House bill generally would give a 7-percent "investment credit" for new machinery and equipment, with a 3-percent "credit" for public utilities, in addition to 100-percent depreciation. This would allow investors up to 114 percent of what they paid for the asset.

The Senate committee bill generally would give a 7-percent "investment credit" for new machinery and equipment, with 3 percent for public utilities, in addition to 93 and 97 percent depreciation respectively. This would allow investors up to 107 percent of what they paid for the asset.

Evidence given in hearings on this bill clearly shows that "investment credit" is both wrong in principle and unnecessary. Numerous witnesses, including those representing four major segments of the economy, opposed the principle involved.

In view of the testimony in the published record on this proposal, it is difficult to understand the persistence of the "investment credit" advocates. Leaders of industry, business, labor, and agriculture all have appeared before the Senate Finance Committee to oppose it.

Stanley H. Ruttenberg, research director, AFL-CIO, urged the committee to "delete this provision from the bill," because those he represented thought:

> It is a multibillion-dollar windfall that will not really contribute anything to our national goals and will not relieve our balance-of-payments problems as it is claimed.

Walter Slowinski, appearing in behalf of the U.S. Chamber of Commerce, with respect to the "investment credit" provisions, said:

> The chamber again recommends against the adoption of this novel and untried preferential tax credit subsidy for business. It is also unnecessarily complex, and it will be difficult to administer.

Harold H. Scaff, chairman, Tax Committee, National Association of Manufacturers, said "investment credit"—

> would simply provide reduction in effective tax rates for taxpayers who use their income and other funds as the Government thinks is best for the economy at a particular time.
>
> There has been a tendency to promote and discuss the investment tax credit apart from the price which it would exact in terms of other changes in the tax law. Even without the exaction of such a price, we would oppose the credit

> for the reasons set forth in the appendix attached hereto. Very simply, we believe that tax reductions should be afforded by direct means. We would take this position even if, in our opinion, all of the other provisions of H.R. 10650 constituted sound tax policy.

Charles B. Shuman, president, American Farm Bureau Federation, took the position that—

> these provisions are both unsound and likely to have a number of undesirable effects. It would be far better to liberalize the treatment of depreciation and work toward a general reduction in income tax rates.
>
> The proposed investment credit is a selective form of tax relief—in reality a subsidy. * * * The result would be to give some taxpayers a competitive advantage at the expense of others.

Although the Farmers Union did not send a representative to testify directly before the Finance Committee, a communication signed by James G. Patton, president, National Farmers Union, published in the congressional record of March 29, 1962 (p. 4984), said:

> Urge your influence to delete provision giving huge private corporations operating at less than full capacity over $1½ billion and private electrical power monopoly over $100 million in tax subsidies which would result in the flight of capital overseas and further aggravate the dollar crisis.

The "investment credit" proposal would be discriminatory in obvious respects. It would discriminate against companies which were recently modernized, against poorer companies, and against companies needing new buildings with or without new machinery and equipment.

The very fact that "investment credit" would give special tax reduction only to those companies able and willing to invest in new machinery and equipment means that those who for any reason were unable to make such investments would be subjected to discrimination.

Struggling small companies unable to provide the funds for qualifying investments would not be eligible for the "credit," but their more prosperous competitors could reap a windfall from the Federal Government through special tax treatment.

None of the proposals—administration, House bill, or Senate committee bill—would give "investment credit" for new buildings or structural components. It is difficult to imagine installing expensive modern machinery and equipment in an old, outmoded building.

INEFFECTIVE AND QUESTIONABLE

Plans for new facilities contemplated by advocates of the "credit" are formulated far in advance. Many of those who would benefit from the proposal would have developed their improvements without the incentive of "investment credit."

In such cases the "credit" would be of questionable value as a stimulant to "economic growth." On the other hand, the proposal offers neither incentive nor immediate means of expansion for companies which are hard pressed for capital.

A recent McGraw-Hill survey developed the consensus that this "investment credit" proposal would increase 1962 investments by only about $300 million, or 1 percent. This raises the question of the effectiveness of section 2 as a stimulant for increased investment.

Witnesses before the Finance Committee also raised the question as to the effectiveness of "investment credit" in this respect. For example, Augustus W. Kelley, representing the Proprietary Association, said:

> The theory of the tax incentive in our opinion is based on the false premise that business investments are motivated substantially by tax considerations. In our industry, and we believe it is typical of others, the decision whether or not to invest in new machinery and equipment is based primarily on pure business consideration. Simply stated, we are not going to spend $1 just because the Government gives us 7 cents.

Otis H. Ellis, speaking for the National Jobbers Council, said:

> This tax credit will not be enough to induce a single jobber to buy one item more than what he would otherwise have purchased.

The McGraw-Hill survey, previously referred to, indicates that without the "investment credit" business investments in plant and equipment this year may be expected to reach some $38 billion. This would be $1 billion more than the previous record set in 1957.

If $38 billion is spent in new plant and equipment this year, it will exceed such investments of last year by $3.5 billion or 11 percent; and the same survey finds reason to expect continuing high level of investment for the period of 1963–65.

We believe the sound way to achieve a reduction in taxes is first to cut unnecessary Federal expenditures as a means of putting the Nation on a sound financial basis.

We do not believe that tax reductions should be discriminatory by favoring some taxpayers over others in the manner inherent in the "investment credit" proposal or otherwise.

We believe that revisions in the Federal revenue structure should not create new discriminatory and artificial distinctions among taxpayers such as this proposal would establish in the law.

We believe our attention should be directed toward reducing rather than increasing such inequities.

HARRY F. BYRD.
ALBERT GORE.
JOHN J. WILLIAMS.
CARL T. CURTIS.

ADDITIONAL VIEWS OF SENATOR EUGENE J. McCARTHY ON H.R. 10650

In my opinion, neither section 2 of this bill, on the investment credit, or section 12, on controlled foreign corporations, provides an adequate solution to what are admittedly two important problems, and neither of these two sections is defensible in terms of equity or of administrative simplicity which should characterize our tax system.

INVESTMENT CREDIT

The tax credit for "qualified investment" is designed to stimulate what has been termed "a sluggish economy." I have no argument with the fact that our economy would profit from modernization of plant and equipment and from the expansion of certain productive facilities—even though we have substantial underutilization of productive capacity in many areas—but I question whether a selective and hence discriminatory tax credit is the cure for the Nation's investment maladies or economic problems. In my opinion, comprehensive business tax relief in the form of a general reduction in the corporation income tax, together with an across-the-board reduction in personal income tax rates, will better meet these needs by freeing money both for new investment and for consumption without binding business decisions to Government decisions and without creating the problem of distinguishing between qualified investment and nonqualified investment.

The investment credit as it stands in this bill today is but a pale representation of the original administration proposal. In his testimony before the Committee on Ways and Means in May 1961, Secretary Dillon said:

> * * * the purpose of the investment credit is not to provide general tax reduction for recipients of profit income. Rather it is to stimulate investment in the most efficient manner. The credit, therefore, should be focused on investment which would not have been undertaken without this inducement, and which will be most responsive to the stimulus which it provides.

Originally the administration recommended a 15-percent tax credit, most of which would have been available only for plant and equipment expenditures in excess of current depreciation allowances. A 6-percent credit was provided for certain investment below the level of those allowances, and a 10-percent credit on the first $5,000 of investment was provided whether it was more or less than depreciation allowances. The credit was not to be limited to tangible personal property, but also was to be available for most buildings and their structural components as well. The credit also was not to exceed

30 percent of a firm's tax liability. A 5-year carryforward of unused tax credits was provided.

The investment credit which passed the House in March of this year contained the following major changes: (1) A tax credit of 7 percent was granted on all new investment in eligible property, regardless of current depreciation allowances; (2) public utilities, excluded from any credit under the administration plan, were allowed a 3-percent credit; (3) the full credit was made available for assets with a useful life of 8 years or more and scaled down for assets with a useful life of 4 to 8 years; (4) the credit was limited to $25,000 plus 25 percent of a company's tax liability over this amount; (5) the property eligible for the credit excluded buildings and structural components as well as certain other property.

The Senate Finance Committee has made further changes, adding a 3-year carryback for unused tax credits, changing the effective date of the credit from January 1, 1962, to July 1, 1962, and stipulating that the depreciable base of property eligible for the credit shall be reduced by the amount of the credit.

The result of most of these changes has been to reduce the impact of the investment credit. Section 2 is now little more than a tax-relief measure, but the relief is restricted in its application to certain firms investing in certain types of property.

What is wrong with the investment credit provided in this section? In the first place it is highly selective as to the type of investment which may qualify and as to the time when this investment must have been made. Individual air-conditioning units qualify but central air-conditioning systems do not; transient hotels qualify but residential hotels do not; cattle fences qualify but the cattle themselves do not. How are we to make sense out of a provision which substitutes the Federal Government's wisdom for that of the private sector in ascertaining what type of investment is required for the economic health of individual business enterprises? Not only does the section differentiate between types of assets, but it also makes an arbitrary determination, based on the expected life of the asset, as to how much, if any, credit will be allowed.

Furthermore, the credit discriminates between investment undertaken before and after July 1, 1962, in effect rewarding those business concerns which have for one reason or another failed to modernize and to expand prior to the effective date of this section. How can we justify a plan which announces to one group of businesses that they invested too early and are, therefore, not eligible for the 7-percent credit while telling another that they have waited until the proper time, that they have waited until the Government can step in with a special inducement for technological developments?

Secondly, the credit would be granted for qualified investment irrespective of the plans or obligations of a particular business. This is most obvious in the case of public utilities but applies also to any firm which has faith in the dynamism of the American economy and in the stability of our political and social institutions. Many businessmen have commented that the tax credit would have slight, if any, effect on their investment plans. Considered in this light, section 2 is, in a sense, a windfall which would benefit some of our industrial giants, leaving smaller and depressed businesses in the same cash-shy position as before. In the final analysis new investment is dependent not upon a taxsaving of perhaps 1 or 2 percent of a company's estimated income tax, but upon the company's expectations of profits through the marketing of its goods or services. Businessmen invest because they have reason to believe that they will sell. Most business witnesses indicated preference for accelerated depreciation, together with straight tax reduction.

The Treasury's new depreciation schedule which went into effect in July of this year is a step in the right direction and, in my opinion, should be carried even further.

There is near unanimity among leaders of both labor and management that the investment credit is unsound and ill-suited to the problem which it seeks to solve.

CONTROLLED FOREIGN CORPORATIONS

Provisions of this bill for taxation of controlled foreign corporations threaten to upset established business practices both at home and abroad at a time when economic conditions throughout the world are changing rapidly and when nations are attempting to reevaluate and redfine their trade positions. Testimony before the Finance Committee indicated that the competitive position of many American firms operating in foreign countries may be seriously jeopardized because of the uncertainty and because of the penalties in this section.

Many American corporations have established subsidiaries abroad in order to take advantage of business opportunities in an expanding international economy. Subsidiaries have been set up to protect old markets and to penetrate new ones. These actions have increased the domestic business of the companies, have created jobs for U.S. workers, and in the case of most firms have resulted in a dollar return to the United States from the oversea business in excess of the amount invested abroad.

Many changes have been made in this section of the bill since the administration's initial recommendation of last year. The original proposal was to eliminate tax deferral for all controlled foreign corporations except operating subsidiaries in developed countries.

The House-passed bill eliminated deferral for the so-called foreign-base company income of tax havens unless it was reinvested in less-developed countries, and for operating subsidiaries unless their income was reinvested in the same business outside of the United States or in a less-developed country. Now the Finance Committee has adopted amendments which would leave the tax deferral for manufacturing subsidiaries intact while continuing tax deferral for foreign-base company income only if it is earned, as well as reinvested, in less-developed countries. The committee also voted to include income from services within the definition of foreign-base company income and to permit deferral if certain minimum distributions are made to U.S. shareholders, according to a formula which takes into account the effective tax rate of the foreign country in which the subsidiary is located. Finally, tax deferral has been continued for companies which qualify as export trade corporations.

In addition to these fundamental changes, there have been a number of other modifications. The definition of controlled foreign corporations affected by section 12 has changed; the tax treatment of patents sold or transferred to foreign subsidiaries has changed; corporations organized in Puerto Rico or possessions of the United States have been exempted; greater recognition of the losses of foreign subsidiaries has been provided; and there have been many other changes.

These changes improved the bill, but are of limited good and do not eliminate the basic difficulties which would result from the passage of this section.

Many American firms would suffer in trying to compete with foreign competitors which enjoy the tax advantages while locating where they will. Companies with contractual commitments or indebtedness abroad would face an uncertain future, as would companies which can sell abroad only through sales subsidiaries because their volume is insufficient to justify expenses of establishing and operating a plant. This section would, in fact, serve as an invitation to foreign countries to increase their taxes on American subsidiaries, as such taxes can be credited against the U.S. taxes.

In a broader sense, the controlled foreign corporations provision erects a barrier to the achievement of vital national objectives, namely the expansion of trade and an improvement in our balance-of-payments position. We cannot promote either of these related objectives through a restrictive policy which, in the hope of correcting tax abuses, slashes with a broad sword at America's oversea subsidiaries.

In addition, section 12 raises certain constitutional questions. Can the United States tax a corporation's income to the shareholder before it is realized by the latter? Does the bill discriminate between different classes of shareholders in contravention of the fifth amendment? Would the United States be acting in violation of treaty obligations with foreign nations?

There are controlled corporations which have been established in foreign countries primarily, if not solely, for purposes of tax avoidance here in the United States. It is also true that some of these subsidiaries probably serve no real purpose as far as the interests of the United States are concerned. We should not throw the baby out with the bath water but should reconsider the means by which we undertake to correct abuses.

The fact that this section as originally proposed by the Treasury has been changed drastically in the House and Senate suggests strongly that this approach to oversea income is far too complex in its administration, far too selective in its application, and far too uncertain in its effects.

WITHHOLDING

The Senate Finance Committee eliminated the section which imposed withholding tax on interest and dividend income. This section had been proposed as a means of collecting a substantial portion of the estimated $850 million per year of taxes on interest and dividend income which, either because of ignorance of the law or dishonesty, is not paid. On the proposition that every person should pay his just taxes there can be no disagreement. The proposition, on the other hand, that to achieve this objective we should shift the burden of collection from the Government to the private sector of the economy and create unprecedented administrative complexities is, I believe, open to serious challenge.

Withholding on wages cannot be compared directly with withholding on interest and dividends. The former is imposed on the principal source of income for the vast majority of Americans. In most cases an individual derives his wages or salary from a single source rather than from several sources as in the case of many taxpayers who receive interest and dividends. Even though our law provides for withholding from zero to 18 percent on wages and salaries, according to income and exemptions claimed, there has been overwithholding on as many as 40 million returns in a single year. In the case of interest and dividends, where a flat 20 percent would be withheld, we could expect overwithholding, in proportion to the number of returns with taxable income from these sources, to be considerably higher than overwithholding on wages and salaries. The quarterly refund and exemption certificate procedures included in the House bill would not alleviate the hardship and inconvenience created for many taxpaying citizens and institutions, and would, of course, complicate still further an already difficult administrative task.

One of the time-honored criteria of a good tax system is administrative simplicity and ease of compliance. The proposed withholding tax, with its exceptions and complications, would burden payors, recipients, and the Government itself. The collection of withholding on interest payments would be especially difficult because of the large number of small accounts, but similar difficulty exists with reference to dividend payments. Estimating tax liability and determining the exempt or nonexempt status of each interest and dividend recipient, knowing when an individual's status may change and adjusting his records accordingly, learning which types of payments are exempt, applying credits for individuals, governmental units, and tax-exempt organizations—these are among the many problems which would arise. Plans to apply the withholding tax more selectively, either by exempting persons with annual incomes of $5,000 or less or by exempting payments of $10 or less per year on any one account, would introduce additional complexities.

It appears that attempts to introduce equity into withholding only complicate its administration, while attempts to ease administrative problems would only result in serious inequities.

There is good reason, I believe, to expect much improved compliance in the future with existing tax laws, partly because of a public information program on the part of business and Government. Automatic data processing will soon be in operation and should help the Government to enforce tax laws while standing as a modern, mechanical reminder to taxpayers of their obligations. Section 19 of this bill now requires interest and dividend payors to report to the Government all payments of $10 or more during the year and to furnish each such recipient with a statement of his aggregate amount of payments. The Federal Government has required that every person who files a tax return be assigned an identification number which shall appear on all of his tax documents. Perhaps the Internal Revenue Service may even devise an improved tax form which would give greater prominence to interest and dividend income.

Together, all of these should add up to much improved reporting of interest and dividends and improved collections. Certainly for the sake of the taxpayer, businessmen, and the Internal Revenue Service, these methods should be tried more thoroughly. Only if these efforts and methods prove inadequate after fair and full trial, should withholding methods be applied.

EUGENE J. MCCARTHY.

DISSENTING VIEWS OF SENATORS FRANK CARLSON, WALLACE F. BENNETT, JOHN MARSHALL BUTLER, CARL T. CURTIS, AND THRUSTON B. MORTON ON SECTION 11—FOREIGN SOURCE INCOME, H.R. 10650, AS AMENDED BY SENATE FINANCE COMMITTEE

The provisions for the taxation of foreign source income as set forth in sections 11 and 15 of H.R. 10650 as reported to the Senate are truly amazing. Eleven volumes of hearings by the Committee on Finance have been published since April 2, 1962. They include the testimony of 200 witnesses and statements by 300 additional taxpayers. In spite of virtually unanimous opposition by witnesses from industry, agriculture, the accounting and legal professions, and distinguished academicians and economists, these amendments are now before the Senate. The enactment of these provisions will produce no appreciable revenue, will have an ultimate adverse effect on our balance of payments, will discourage U.S. foreign investments, will hamper our export trade, and will invite retaliation and generate friction with our friends and allies. If the provisions of these sections are enacted into law, normal trade relations will be seriously disturbed.

There is a serious question as to the constitutionality of the basic concept of taxing the earnings of foreign subsidiaries which have not been constructively received by U.S. taxpayers.

Section 11 proposes that a tax be imposed on increase in net worth which has long been held unconstitutional. If such a theory is accepted as proper, there is no reason why every stockholder would not be assessed a tax on the increase in the value of his security during any given period of time, whether such an increase has been a taxable gain or not.

Section 11 completely disregards corporate legal entities, legitimate in purpose or otherwise. It disregards the spirit, if not the letter, of existing tax treaties and conventions which have taken years to negotiate by both Republican and Democrat administrations. It provides for a tax on imputed income. If a U.S. domestic taxpayer has not received funds to pay this tax, it must be paid by reducing the availability of funds for employment or investment in this country.

It encourages U.S. direct investment in foreign securities rather than in U.S. owned and operated foreign subsidiaries. Clearly such investments will reduce America's competitive position in world markets and in all likelihood will have an additional adverse effect on our short and long term balance of payments position.

It imposes an unfair competitive burden on foreign subsidiaries of U.S. corporations, since no foreign government imposes similar taxes on local competitive enterprises. It establishes undue hardships resulting from differences in accounting practices employed by foreign versus U.S. companies. Section 11 provides that the accounting practices applicable to domestic corporations shall govern the determination of foreign source income on which a tax is to be levied. Necessarily, in most instances this will require the maintenance of two sets of books and accounts—one to meet the needs of the foreign operation and the second to determine U.S. tax liabilities. This procedure will impose unwarranted costs on many small enterprises. Furthermore, if a subsidiary has a substantial foreign minority interest, the entire cost of duplicate records will have to be borne by the domestic, parent corporation, thus reducing its income and tax liability to the Federal Government. It would create a powerful incentive to the governments of foreign countries to levy special taxes on the income of subsidiaries of U.S. companies.

Necessarily the determination of subpart F "income" includes the conversion of foreign earnings into dollars at the existing rate of exchange which may be favorable or unfavorable at the time. If a tax is paid to the Federal Government by the U.S. parent corporation and at a subsequent date the exchange rate between the dollar and the foreign currency is changed, there is no recourse by the U.S. parent corporation for the unjust enrichment to the U.S. Government.

Furthermore, the language contains unprecedented delegation to the Secretary of the Treasury or his delegate to prescribe by regulation concepts which should be embodied in substantive legislation itself. The delegations leave so much to administrative fiat that they represent an abdication of congressional authority over taxation. By their terms, they warn business that the tax burden is subject to change by administrative decree. This fact alone inhibits orderly planning and makes the risks of capital investment abroad very uncertain.

There is also the possibility that in some instances American interests in foreign operations will be transferred to foreign firms because of their inability to finance the payment of these additional taxes. Such an eventuality would greatly weaken the U.S. competitive position in world markets.

Section 15 "Sales and Exchange of Patents to Certain Foreign Corporations" as reported to the Senate once again abandons long established practices and discriminates against American corporations doing business abroad. It would tax the sale and exchange of capital assets in a different manner than they are taxed in domestic transactions. Since the proponents of this legislation have stressed the need for neutrality of taxation on foreign and domestic activities, these discriminatory provisions clearly show that neutrality is not provided in this proposed legislation.

The enactment of these provisions will be bewildering to American business and to the Internal Revenue Service itself. They will foster serious litigation and demand court interpretation before the true meaning of the language reported by the committee can be applied to actual business transactions.

THE ADMINISTRATION'S OBJECTIVES

President Kennedy first presented his tax recommendations to the Congress on April 20, 1961. They included basic changes in the concepts for the taxation of foreign source income. His message suggested that existing law which does not tax the unrepatriated earnings of foreign subsidiaries had played an important role in recent years but that it should now be abandoned. The President stated that:

> Changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few years, compel us to examine critically certain features of our tax system which, in conjunction with the tax system of other countries, consistently favor U.S. private investment abroad compared with investment in our own economy.
>
> * * * Many American investors properly made use of this deferral in the conduct of their foreign investment. Though changing conditions now make continuance of the privilege undesirable, such change of policy implies no criticism of the investors who so utilize this privilege.[1]

It should be noted that the President clearly stated that he did not regard the so-called principle of deferral as an improper practice or a form of tax evasion. However, there is an implication that so-called deferral represents a privilege, and is a relatively new concept in our tax laws and perhaps was enacted in order to promote the aims of the European recovery program under the Marshall plan. This is not a fact, as the basic concepts of taxation applicable to foreign-source income have been included in the Internal Revenue Code since its inception in 1913. Furthermore, they are found in the tax laws of every other country.

Secretary Dillon, in his appearance before the House Ways and Means Committee, in May 1961, advocated the elimination of deferral in developed countries as he believed such action would further several desirable objectives. They included the improvement of our balance-of-payment position, increased U.S. tax revenues, the achievement of "tax neutrality," which, in turn, he suggested, would result in additional domestic employment by the promotion of added exports and encouragement for additional investment in the less-developed countries of the world.

Extensive hearings were conducted by the Ways and Means Committee, and representatives of every sector of the business community appeared in opposition to this marked change in the concept of taxation. Their testimony clearly showed that the operation of foreign subsidiaries promoted our exports, and that the balance-of-payments position had been favorably affected by the existence of direct foreign U.S. investments. In fact, Secretary Dillon conceded that after a period of approximately 17 years, our balance-of-payments position would be damaged by discouraging any further direct U.S. foreign investment as the administration recommended. When such changes are proposed, there must be compelling and convincing reasons.

U.S. direct foreign investments total more than $50 billion. They constitute one of the Nation's most valued assets. If, as a result of the enactment of this measure, foreign investments by American firms are discouraged, the economy of this country will be adversely affected.

The testimony presented before the House Ways and Means Committee clearly showed that over the 15-year period ending in 1960,

[1] President's 1961 Tax Recommendations, hearings before the Committee on Ways and Means, House of Representatives, 87th Cong., 1st sess., vol. 1, p. 8.

receipts from direct investment exceeded current outflows by nearly $10 billion. Certainly this data does not support the contention that foreign direct investments adversely affect our balance of payments.

The testimony also showed that the taxes levied on the remittance of dividends to U.S. parent corporations on their direct oversea investments have been a substantial source of income to our Government. The witnesses who appeared showed that it was impossible to accomplish "tax neutrality" in the sense advanced by the administration. True neutrality must respect the business facts of life and insure that competition may take place on a basis of neutrality in the marketplace.

The Congress of the United States cannot determine the tax laws that will be applicable in other countries, not only with respect to their own nationals but to those of other countries as well.

Furthermore, the hearings before the Ways and Means Committee clearly showed that there was no basis to support the contention that by restricting investments overseas, additional investment would occur in the United States—thus providing employment opportunities for our people and increased exports. On the contrary, the testimony indicated that virtually every U.S. firm would prefer to operate entirely within the jurisdiction of the United States, and export its production to world markets. However, a multitude of reasons have necessitated the establishment of foreign operations if the United States is to enjoy its share of participation in foreign markets. U.S. firms are confronted with a choice of either abandoning these markets or of establishing appropriate facilities to meet the competition already present or which is expected to be established to penetrate such markets.

The concepts originally advanced by the administration in 1961, with modifications to meet the more obvious discriminations, are the basis for H.R. 10650 as reported by the Committee on Finance. While this measure is still supported as a means of providing what the administration chooses to call "tax neutrality," it is quite apparent that no enactment by the Congress could achieve this result.

Our citizens should be in a position to compete in any country of the world with the nationals of other developed nations. Such competition may take the form of exports from the United States, licensing of patents and processes to a foreign firm, or the operation of manufacturing and distribution facilities in foreign countries. The decision as to the best combination of business activities must be determined on the basis of all of the factors involved in a given market as well as whether firms established in other nations are free to make what, to them, appears the most desirable economic choice. It is a disservice to place American firms in a position where their freedom to compete is restricted.

Contrary to the views advanced by the administration, American business does not go abroad because of a more favorable tax climate, but because on the basis of business judgment, it appears that a profit can be achieved by establishing a foreign operation. Business is rarely confronted with a choice of exporting or operating abroad. It is rather the choice of whether to abandon a market entirely or to seek a competitive position therein. In spite of the refutation of the arguments advanced by the administration, the House of Representatives passed H.R. 10650.

The preponderance of the evidence presented to the House Ways and Means Committee and to the Committee on Finance clearly shows that none of the objectives the administration is seeking to achieve would be furthered through the enactment of its proposals with respect to the taxation of foreign-source income.

HEARINGS BY THE COMMITTEE ON FINANCE

Section 13 of H.R. 10650, as passed by the House of Representatives, did not completely eliminate the administration's so-called tax-deferral privilege. Accordingly when the Committee on Finance started its hearings on April 2, the administration once again urged that its original proposals for complete deferral be accomplished by amendments to H.R. 10650. Secretary Dillion stated that:

> 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.[2]

The Secretary endeavored to develop the need for this legislation. He stressed that it would serve two purposes: The first, an improvement of our balance-of-payments position, and second, it would contribute to Federal revenues. However, as the hearings proceeded, several major inconsistencies in the administration's position were developed.

The testimony which had been presented before the House Committee on Ways and Means clearly established that U.S. direct investments had generated a return flow of capital over the past 15 years that was a major factor in preventing a serious balance-of-payments crisis. Nevertheless, Secretary Dillon advanced a new concept by conceding that while the overall balance of payments on all U.S. direct investments abroad was favorable, the return flow on new investments was insufficient in comparison with the current outflow. He testified as follows:

> 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

[2] Revenue Act of 1962, Hearings Before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., on H.R. 10650, pt. I, p. 99.

> 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. * * *
>
> 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, or 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 the 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.[3]

A number of observations are in order with respect to these statements. The formation of the European Economic Community has built a common external tariff barrier around a rapidly expanding market. This has forced U.S. firms to establish new operations within the Community. This single fact accounts for the large outflows to Western Europe during recent years. A single transaction involving the purchase of a foreign interest in the subsidiary of a U.S. firm accounted for a very large portion of the total outflow to Western Europe during 1960. It is idle to suggest that any new investment could possibly generate a return comparable to the investment itself within a few years after its establishment.

It appears strange that the administration would jeopardize the long-term benefits in order to provide a temporary correction of the short-term imbalance. The mere fact that the Secretary of the Treasury concedes that within a comparatively few years, new investments will make substantial contributions to our balance of payments, makes his position untenable. If the $50 billion of foreign investments overseas were not in existence, our present balance-of-payments problem would be acute. If the policies of taxation advanced by this administration had been adopted by the Congress a few years ago, this national asset would not be in existence. Should the Congress follow the Secretary's proposal, it will certainly not continue to grow and provide a greater positive factor in our overall balance-of-payments picture.

It appears likely at this time that for many years to come, perhaps for a generation, there will be a continuing need for foreign assistance and the military support of our allies to prevent further Communist aggression. In this context, the long-term needs of our economy extend far beyond the period that would be benefited by an immediate

[3] Ibid., pp. 447-448.

improvement in our balance of payments. However, the inconsistency in the Secretary's position with respect to the effectiveness of his proposal to eliminate tax deferral as a means toward the correction of an adverse balance of payments is shown in his statement before the committee on April 2. He said:

> * * * 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.[4]

If the U.S. parent pays the tax from domestic sources, there will be no effect on our balance-of-payments position. But capital which would otherwise be available to expand domestic investment in the private sector of our economy would be diverted to the public sector. Clearly the improvement of our balance-of-payments position cannot justify the enactment of section 11 with the many serious consequences to our overall world trading position it would entail.

The Secretary of the Treasury in his first appearance before the Committee on Finance on April 2 continued to stress the need to enact legislation to provide additional revenues. Yet the real impact of the administration proposals with respect to the taxation of foreign source income is revealed in the following colloquy between Senator Carlson of Kansas and the Secretary of the Treasury:

> Senator CARLSON. 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.[5]

It has long been the accepted view that the primary concern of the Congress in levying taxes is to provide funds for the operation of the Federal Government. If a complex measure which will impose burdens on most business enterprises with oversea activities and which will also complicate our international relations will not make a tremendous contribution to our overall revenues, it is strange that the administration would seek to secure the enactment of such provisions under these circumstances.

[4] Ibid., p. 102.
[5] Ibid., p. 440.

In short, the hearings before the Committee on Finance developed the same philosophy and facts as had been presented a year before to the House Committee on Ways and Means. No convincing evidence was presented to substantiate the view that the administration's proposals could either ultimately improve our balance-of-payments position or contribute substantially to the Federal revenue. Nevertheless, the administration has continued to seek approval of a new concept to impose a tax on the unremitted earnings of foreign corporations to American shareholders.

In order to secure the acceptance of this principle, the amendments incorporated in the present version of section 11 do not deal with tax deferral as stringently as section 13 of the bill which passed the House of Representatives. The administration has abandoned its efforts to seek the complete elimination of tax deferral as proposed by the Secretary of the Treasury on April 2. It is now prepared to accept a measure which permits deferral on operations conducted within a given country and even on a portion of what were considered base company earnings such as sales and management activities. Clearly, the issue before the Senate is not the correction of our balance-of-payments position nor the provision of revenues, but rather the acceptance or rejection of an unsound and unwise principle of taxation, which if adopted in the pending bill will establish a precedent for the extension of such a principle into countless other areas. This measure could have no significant impact on either our revenue nor our balance-of-payments position. It cannot promote exports nor contribute to the attainment of any of the objectives outlined by the administration in its original message on taxation to the Congress in 1961. On the contrary, the uncertainty and confusion which even the discussion of these proposals has engendered, deterred some worthy foreign investments. Insofar as direct foreign investments support exports, the continued efforts to secure the enactment of this legislation are a disservice to our citizens whether they be investors or employees seeking broader opportunities. Our farmers and miners, whose economic position is directly effected by the strength of our overall efforts in world markets also have a vital stake in this matter. It is apparent that many of our citizens are confused with respect to the impact of the proposed legislation on our domestic economy. Nevertheless, the testimony from every sector of the business community clearly shows that if these concepts are enacted into law, the welfare of our own citizens who may not realize they have a stake in direct foreign investments will be adversely effected.

COMPLEXITIES OF SECTION 11

The language proposed by the Committee on Finance in section 11 "Controlled Foreign Corporations" is unnecessarily complex and confusing. The attempt to impute an amount to be included in the gross income of U.S. shareholders based on the earnings of controlled foreign corporations necessarily presents difficulties that repeated amendments have been unable to clarify. The Congress under the Constitution is responsible for the enactment of legislation which clearly defines the tax obligations of our citizens. The substantive determination of tax liabilities should not be delegated to the executive branch of the Government.

87490—62——24

Section 11 provides that many substantive matters are to be determined by the Secretary of the Treasury or his delegate. The number of instances in which the Congress would abdicate its constitutional responsibilities by this delegation of power suggests that the concepts underlying this proposed new section of the Internal Revenue Code have not been clearly defined and perhaps can never be so defined. The requirement that the determination of the earnings of controlled foreign corporations follow the concepts of the U.S. tax laws is unrealistic, since these corporations operate under the laws of other nations and the tax credits, the rules for depreciation, and numerous other basic concepts differ widely from the U.S. law and the rules and regulations for its implementation prescribed by the Secretary of the Treasury. Furthermore, earnings are computed in foreign currencies and the apportionment of the U.S. parent corporation's share of such earnings requires their conversion into dollars at an arbitrary value. The language in the proposed amendment does not provide for the return to the taxpayer of any taxes that were paid on unrepatriated earnings that subsequently could not be realized in equivalent dollars because of currency devaluation or other factors operative after the assessment of the U.S. tax. The language in section 964, subsection b, "Blocked Foreign Income," provides:

> (b) BLOCKED FOREIGN INCOME.—Under regulations prescribed by the Secretary or his delegate, no part of the earnings and profits of a controlled foreign corporation for any taxable year shall be included in earnings and profits for purposes of Sections 952, 955 and 956, if it is established to the satisfaction of the Secretary or his delegate that such part could not have been distributed by the controlled foreign corporation to United States shareholders who own (within the meaning of section 958(a)) stock of such controlled foreign corporation because of currency or other restrictions or limitations imposed under the laws of any foreign country.[6]

However, it fails to grant relief for taxes paid prior to the time that earnings could not be transferred. Furthermore, the assessment of a tax unrepatriated earnings insures that the U.S. Government derived revenue even though such earnings are based on accounting procedures which anticipate levels of activity for future income which may not be attained.

The burden of maintaining the records and accounts provided in subsection C of section 964 will impose additional costs on domestic parent corporations, as in almost every instance it will be necessary to maintain duplicate sets of records and accounts—one, to conform with the accounting procedures of the foreign country in which the operation takes place, and the second, for the computation of U.S. tax liabilities.

These activities do not contribute to the productivity and growth of our economy. They are a luxury that we cannot afford at this critical juncture in world history.

The committee received testimony on behalf of a distinguished group of New York attorneys who are specialists in matters involving taxation.

---

[6] H.R. 10650, 87th Cong., 2d sess., sec. 964, subsec. b.

Mr. Robert J. McDonald, a member of the group testified that:

We believe, however, that the present bill does not effectively distinguish between avoidance devices and legitimate business operations conducted outside of the United States.

Further, we believe the foreign income provisions are unworkable, are unduly penal in their impact on the foreign business of the U.S. persons, and may have many consequences that are clearly adverse to the interests of the United States.

The foreign income provisions are unworkable because they are so complex that they cannot reasonably be understood or administered, and because their application depends upon detailed historical and current information that will often be impossible or impractical to obtain.

They are unduly harsh and, in many cases, penal in effect in imposing burdens of taxation and of administrative compliance that are much more extensive than in the case of domestic operations, particularly in their impact on the individual foreign investor. Moreover, no opportunity is provided to adjust legitimate business arrangements established in reliance upon existing law and, indeed, at the urging of our Government.

These provisions would have numerous consequences that are clearly undesirable and often unintended. The substantially favor foreign competitors who are not subject to similar burdens, even though the committee report notes that one of its guiding policies is to avoid weakening the competitive power of American business abroad.

Now, in determining the pro rata share of a corporation's increase in earnings invested in nonqualified property, not only must there be a determination of the earnings and profits for the year and the earnings and profits accumulated since December 31, 1962, but there must also be a review of the financing business needs and underlying nature of the business of the foreign corporation and of any changes made therein.

To make these determinations requires the application of a series of imprecise concepts, and the availability of information extremely difficult to obtain.

The determination of earnings and profits for the year or for the period since December 31, 1962, of foreign corporations presents problems which will be insurmountable in a substantial number of cases.

These determinations are dependent not only on U.S. concepts of tax accrual, tax deferments, tax elections, basis, tax exempt income, amortization and depreciation, and numerous other items completely alien to the foreign corporations and foreign accountants, but it is also affected by reorganizations, liquidations, exchanges, and distributions in kind which may or may not be tax free by American standards.

> There are no provisions whatsoever under the bill for making these determinations or provisions establishing the machinery therefor.[7]

The statement presented to the committee on behalf of these attorneys by Mr. McDonald included numerous examples to show the possible undesired consequences of enactment of the administration's proposals. The statement included a section on the unworkability of the bill which suggest that the Internal Revenue Service will be confronted with the same difficulties that were perceived by these attorneys in their examination of these provisions. Mr. McDonald stated:

> The bill's provisions in respect of foreign income are so complex, overlapping, and replete with unprecedented tests that it is difficult to analyze them. The members of this group submitting this report are experienced in matters of tax law; they have spent over 40 hours in group discussion and countless hours of individual study reviewing the contents of the aforementioned sections. Despite this, the practical problems of working with the proposed legislation are so immense that the group has found it difficult to understand the bill and impossible to measure its full impact. So many new concepts are included in the bill that a definite technical analysis by tax practitioners has been virtually impossible. The complexity of its provisions can only cause uneven and arbitrary enforcement and administration of the bill. Skilled tax practitioners will undoubtedly find technical loopholes. On the other hand, many U.S. entrepreneurs will by chance find themselves caught by extremely harsh provisions of the bill which by proper planning could have been avoided. Revenue agents cannot be reasonably expected to understand the provisions or to enforce them uniformly. Thus, the impact of the bill will be haphazard.[8]

In view of the fact that the enactment of section 11 will make no significant contribution to Federal revenues nor will it improve our balance-of-payments position, it is inconceivable that the Congress would enact legislation which contains so many ill-defined, complex, and conflicting provisions.

ADVERSE EFFECTS

Many witnesses who appeared before the Committee on Finance expressed concern at the serious and unintended adverse effects which the enactment of this legislation would produce.

Mr. Leslie Mills, chairman of the Committee on Federal Taxation of the American Institute of Certified Public Accountants, testified that:

> Not the least of the evils which would plague business if these sections are enacted is the authority given to the Treasury Department to make unilateral determinations affecting the tax burden of the domestic corporation. In

[7] Revenue Act of 1962, Hearings Before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess. on H.R. 10650, pt. 7, pp. 3137, 3139.
[8] Ibid., pp. 3147, 3148.

many provisions authority is given to the administration, including the Treasury Department, to make unilateral determinations, from which no appeal appears possible. As one example, a formula is provided for allocating income under certain circumstances, with a further provision that intercompany prices may be determined on an arm's-length basis. However, determination of the arm's-length character of transactions is subject to rather rigid rules which may not give effect in every case to all of the pertinent factors. Moreover, if such arm's-length determinations by the taxpayer are not satisfactory to the Treasury Department, that Department through its agents can determine the allocations which in its sole judgment are proper, without any opportunity for an impartial appraisal. This, and similar approaches to these most difficult problems leave American business operating abroad entirely at the mercy of our bureaucracy. This uncertainty alone will surely cause American business to restrict operations abroad. It certainly creates no climate for new expansion. * * *

I have endeavored to point out that the complexities in this area, and in other parts of the bill, are by themselves serious. The very existence of uncertainties hampers business. Adding these complexities to the already complicated problems of doing business abroad will have the effect of discouraging many small businesses from expanding into the international trade area. The legislative history of the bill in the foreign income area emphasizes this important problem. Business enterprises have been forced to consider a regular series of proposals in the foreign area throughout the past year, and each one has required the immediate initiation of planning to avoid the severe and haphazard penalties which would be incurred under their present organization and manner of doing business. The latest proposals are only a few weeks old, and it cannot be expected that the picture is at all clear for the many organizations, large and small, which will be vitally affected. Yet the most basic provision, with respect to income of controlled foreign corporations, would become effective less than 9 months from now, and presumably just a few months after the final form of the provisions are known if they are approved by the Congress. The far-reaching provisions concerning liquidation and sale of stock would become effective upon enactment. At the very least, therefore, businesses should have more time to turn around and reorganize their activities to avoid possible destruction of their interests. It seems particularly inappropriate to legislate such far-reaching, new, and untried concepts in our tax structure at the very time when the Treasury Department is on record as preparing to release in the near future proposals for a basic reform of the tax structure.[9]

[9] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess. on H.R. 10650, pt. 2, pp. 546, 547.

Another witness, Mr. Tyrone Gillespie, assistant to the president of the Dow Chemical Co., in his testimony stated:

> If the foreign income concepts are enacted into law, our company and all other companies similarly situated will be faced with the severe problem of trying to determine whether the accounting principles and methods of our foreign subsidiaries are compatible with those in the United States, and whether in those cases where we have less than 100 percent ownership, it would be possible to do so in fairness, or at all, without full concurrence of other stockholders. In any case, it would be necessary to maintain two sets of records, one to comply with foreign law and one with U.S. law, and there is a question as to where such records should be kept.
>
> In order to comply with U.S. law, much of the information will have to be estimated because data are not available under foreign accounting systems, and certainly companies will have a built-in and continuing argument with the Treasury Department as to whether their estimates are proper or improper. We are certain that the committee is cognizant of the vast enforcement costs which will be entailed for worldwide policing most of which will gain little revenue so we will not elaborate on this point.
>
> Another question which gives us concern is our company's position if we disclose certain data and economic information of a company in a foreign country in which we are a part owner, where the laws of the country prohibit such disclosure. Does this U.S. law force us to commit economic espionage and thereby render us liable under the laws of our host country? [10]

The uncertainty alluded to by the two witnesses just cited presents a serious problem not only for the business community but for the Congress, as indecision by responsible management at this time can result in a slackening in our economy growth and a failure to provide adequate job opportunities for our growing labor force.

Furthermore, such uncertainty will not only adversely affect the earnings of business enterprises but will result in a decline in Federal tax revenues. Dr. Dan Throop Smith, professor of finance at the Harvard Graduate School of Business Administration and a former Assistant Secretary of the Treasury, posed a number of problems which may beset American business should this legislation be enacted. He informed the committee that he was undertaking a study of all the possible consequences of the pending tax legislation. He summarized his observations as follows:

> Many considerations are relevant to a decision on the taxation of foreign income. I know of no single area where it is so difficult to balance the conflicting objectives of policy.
>
> I have already written a fair amount on the subject, but in recent months have become increasingly interested and concerned with it. I have recently returned from a trip to Western Europe which I took, in connection with current

[10] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess. on H.R. 10650, pt. 8, p. 3607.

research activities, to determine attitudes and practices regarding the taxation of foreign income in some of the industrial countries there. I shall try to state here as concisely as possible what seem to be the most significant points, pending preparation of a longer article on the subject.

Foreign operating subsidiaries are in no sense artificial or unnatural legal entities. Contrary to many foreign holding companies, foreign operating companies are used as the natural and normal means of participating in a foreign economy.

They were used long before we ever had an income tax; in some instances they are required by foreign governments. They are necessary when joint ventures are developed with local capital. It is a misconception to think that they are established primarily for tax advantages.

Furthermore, operating subsidiaries abroad are in competition with other companies located abroad. American parent companies usually establish foreign subsidiaries to maintain a position in foreign markets or to secure a position in new markets.

They do not establish foreign operating subsidiaries as an alternative to expansion at home for production of export commodities. When foreign markets become large enough and foreign conditions for production good enough, production is going to take place abroad.

There are plenty of local companies able and anxious to expand to meet domestic requirements in foreign countries, and plenty of large corporations in other major industrial countries able and anxious to set up their own foreign subsidiaries, and active in doing so.

If our country is to get its rightful competitive share in the expanding income of the world, our business firms must be free to compete where production is taking place.

This point cannot be overemphasized. Someone is going to produce abroad; it is the very essence of economic development abroad that production will take place there. It is a serious misconception to believe that if American firms cannot produce abroad, no one will do so and that foreign demands will remain unsatisfied until filled by American exports.[11]

He further stated:

As markets grow with the rapidly expanding standards of living in the Common Market, it is important to be in on the ground floor, as it were, to have brand names known, to establish distribution channels, and to act promptly in improving products and processes.

If a company falls behind, it can catch up, if at all, only with increased outlays. If it tries belatedly to secure entry into an established market, it can probably do so, if at all, only at greatly increased cost.

[11] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., on H.R. 10650, pt. 7, p. 3089.

These are familiar facts of business which I shall not elaborate, but they should not be overlooked if an argument is made that we need only temporarily to restrain investment, or that old investment is good but new investment is bad, because it is not immediately recouped in repatriated profits.

Business investment must be a continuing dynamic process; it it is not continued as required, the value of old investments, and the possibility of continued repatriated income from them, will wither away.

To the best of my knowledge, and I have inquired carefully, no other country in any way taxes their own companies on the basis of undistributed income of foreign subsidiaries.

Furthermore, on the basis of extensive inquiries in Europe in recent weeks, there is no indication whatsoever that other countries would follow our example.. There is some concern abroad about pricing on transactions between parent companies and foreign subsidiaries—the sort of problem covered by section 482—and in some instances about foreign personal holding companies.

But I found no indication that there was any concern about the undistributed income of foreign subsidiary operating companies or any likelihood that other countries would impose taxes on their own companies similar to those proposed here.

Nor does there seem to be any political controversy or even thought to the contrary on this subject. In one place when I asked if there were arguments to the effect that foreign subsidiaries might lead to a loss of domestic employment the answer was "No; it is recognized that we must have worldwide activities to support the cost of research and development to meet intense international competition. The ability to spread costs over the business of foreign subsidiaries helps assure continued domestic employment."

This reflects the same high degree of sophistication found in most ofthe European labor groups which support, instead of opposing, liberal depreciation as a basis for increased productivity, which in turn leads to higher standards of living and increased employment.

But though other countries will not follow our example in taxing their own corporations on the basis of undistributed income of their foreign operating subsidiaries, it seems very likely that they will be tempted to impose their own special taxes on the U.S.-owned subsidiaries located in their countries.

Does it not seem probable that on practical grounds if there is to be any extra tax on undistributed income of U.S.-owned subsidiaries, the countries where the subsidiaries are incorporated and where the earnings are located will want to exercise their primary right to tax them?

I was asked more than once in my recent trip, by Europeans if I did not think that the countries where the subsidiaries were located would adopt their own laws to secure for themselves the revenue to be derived by new tax burdens imposed by the United States on undistributed income of foreign subsidiaries.

> And, of course, I had to admit that I supposed they would.
>
> The actions of many of our States in imposing soak-up estate taxes to absorb the credit allowed in the Federal estate tax is a perfect precedent. The adoption of anything like section 13 will invite foreign countries to impose their own taxes and it seems likely that many of them will accept the invitation.
>
> To the extent that foreign countries do impose their own soak-up taxes, any expected revenue to the U.S. Treasury will disappear. Increased taxes imposed by our Congress would end up in foreign treasuries, not in the U.S. Treasury.[12]

The possibility of the imposition of new retaliatory taxes by foregin governments would completely destroy the efforts that have been constantly pursued to eliminate double taxation and other hardships which restrict the flow of commerce. It is difficult to reconcile the announced goals of the administration in the Trade Expansion Act of 1962 (H.R. 11970) with the isolationist views toward foreign investment encompassed in H.R. 10650.

A further possible adverse effect which is clearly unintended by the administration is the possible disposal of a sufficient interest in a presently controlled foreign corporation to the nationals of other countries so as to relieve the American parent of the burdens imposed by section 11. This would jeopardize U.S. control over many important trading and manufacturing activities which support our exports and employment in this country.

Again a colloquy between Mr. Robert J. McDonald, a New York attorney representing a group of tax lawyers, and Senator Kerr, of Oklahoma, is significant:

> Mr. McDONALD. They encourage U.S. persons to take minority rather than controlling interests in foreign businesses, with the possible consequences, among others, of loss of a favored position with respect to the sale to such businesses of domestic products.
>
> Senator KERR. Let me interrupt you there.
>
> Mr. McDONALD. They encourage——
>
> Senator KERR. I say, let me interrupt you.
>
> Mr. McDONALD. I am sorry.
>
> Senator KERR. You have just said that, in your judgment, this bill would encourage American investors to take minority positions in foreign corporations rather than American corporations creating subsidiaries in foreign areas.
>
> Mr. McDONALD. We believe it might have that tendency.
>
> Senator KERR. That was one of the points that Dr. Dan Throop Smith made with reference to the investment company which asked for the conference with him and discussed the probability of their increasing foreign stocks in their portfolios of investments, although they are American investment companies, I believe.
>
> Mr. McDONALD. Generally speaking, an American investment company, assuming it is an investment company with

[12] Ibid., pp. 3090-3091.

wide distribution of its stock, would tend not to have a controlling position, and when I say controlling I mean more than a 50-percent interest in the foreign corporation.

Senator KERR. And to the extent that it encouraged investment in minority positions in foreign corporations, it would adversely affect our balance of gold payments rather than favorably affect them.

Mr. McDONALD. It may or may not. I think that is a complicated question. I think that——

Senator KERR. If a situation arose whereby Americans took American dollars and bought stocks from foreign owners and paid for them in American dollars that went over there, that would be adverse in our balance of payments, would it not?

Mr. McDONALD. Temporarily it might.

Senator KERR. Well, the only way that those dollars could come back would be for those sellers to send them back.

Mr. McDONALD. That is correct. And if you did not have controlling positions in those companies there would be less tendency for them to find their way back.

Senator KERR. It would seem to me you were making a point which, I think, is of some significance, and I was asking you the questions only to let the record clearly reflect that as your judgment, if that is your judgment.

Mr. McDONALD. I believe it is.[13]

During the course of the interrogation of Mr. Charles W. Stewart, who appeared in opposition to the administration's foreign tax proposals on behalf of the Machinery and Allied Products Institute, Senator Morton, of Kentucky, presented a hypothetical question which is a further cause for concern in connection with the Senate's consideration of this legislation. The colloquy between Senator Morton and Mr. Stewart follows:

Senator MORTON. Now, you talked to the point of constitutionality which we have dealt with in a rather cursory manner this morning.

I happen to be one of those rare Members of this body who is a businessman and not a lawyer. Sometimes I think the United States would be better off if we were more of us and fewer lawyers here.

As I see the situation in my lay mind, it is comparable to this: Let us suppose that a trucking company in Kentucky had 10 stockholders. Five lived in Tennessee and five in Kentucky.

Let us assume that they made $100,000 after taxes in 1 year. They decided they would pay $25,000 in dividends, that they would retain $75,000 in the business for the purpose of buying new trucks and expanding their operations.

The State of Tennessee has an income tax law. The State of Tennessee would say to those five Tennessee stockholders "but you must pay an income tax based on the earnings of this Kentucky corporation in which you own stock in the

[13] Op. cit., Revenue Act of 1962, pt. 2, p. 678.

> amount of four times what you paid because they earned \$100,000 and they only paid \$25,000 in dividends."
>
> Admitting that is an oversimplification, is that not to a lay point of view somewhat analogous to this constitutional question?
>
> Mr. STEWART. I think you are a much better lawyer than you admit, sir.
>
> I would say that you draw a point here that worries me beyond the scope of this bill.
>
> It seems to me we are breaking new ground if we go to the full route of these provisions in terms of applying the same principle to our domestic tax policy. I am quite concerned about it, and your example is ecompletely on the beam in that respect.[14]

There would be no difficulty in continuing to review other adverse situations which could be most damaging to our economy that were presented to the Committee on Finance by witnesses experienced in every sector of the American economy.

Friendly foreign countries are already concerned with the administration's proposal, and the record of the hearings includes a press account to the effect that President Chiari of Panama has advised President Kennedy that the administration's tax proposal represents "undue interference in the internal affairs of Panama."[15]

President Chiari also declared that the taxation of the earnings of Panamanian corporations on profits which have been unremitted is "almost equivalent to economic aggression."[16]

The Swiss too have expressed similar concerns.

The vagueness of the administration's concepts are illustrated by a colloquy between the Secretary of the Treasury and Senator Curtis of Nebraska.

> Senator CURTIS. * * * Will you define a tax haven company?
>
> Senator DILLON. What we have done is not to define a tax haven company specifically, but to define in effect a tax haven transaction. For example, a tax haven transaction is one where a company incorporated in country A purchases from country B and resells in country C.
>
> So in this situation there have to be three countries involved and the use of the words "tax haven company" is just a short description of companies which operate in this way. We do not have a definition of a company as a tax haven company.
>
> Senator CURTIS. I understand it is not in the proposal, but this is presented to the country and to this committee as reference to a tax haven company, and there are people in Congress and out that are concerned about tax haven companies.
>
> So, I would like to have a definition of the company you are speaking about when you use this term, not the name of the company but what constitutes a tax haven company.

---

[14] Op. cit., Revenue Act of 1962, pt. 2, p. 678.

[15] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., H.R. 10650, pt. 1, p. 653.

[16] Ibid.

Secretary DILLON. Well, I have already given a definition to the Senator. It means companies that operate in the way I have described, that are domiciled in a country generally a very low-tax country; that do business in two other countries. We can give you a list of names of these countries if you desire.

Senator CURTIS. Now, a tax haven company is one that does business with two other companies in two other countries. countries.

Secretary DILLON. What I have said is that in a tax haven transaction where there are two other countries involved, and one of them may be the United States.

It is also a transaction where income for a service, a commission for an item sold, a royalty for a patent, anything you wish, is received from one country by a corporation incorporated in another country.

Senator CURTIS. Now, are all such operations that you have described tax haven transactions?

Secretary DILLON. Not all such operations are necessarily tax haven transactions, and that is the specific reason why I requested in the statement I made yesterday that the Secretary of the Treasury be given authority to exempt specific transactions, specific operations that are not entered into for the purpose of tax avoidance.

I would say that three-quarters or 90 percent of the transactions that I have described are for the purpose of reducing taxes and would be tax haven transactions.

But there are some, and I can give you examples, which are not.

Senator CURTIS. Give me an example of one that is.

Secretary DILLON. One that is?

Senator CURTIS. Yes.

Secretary DILLON. A classic example of one that is, is a U.S. foreign subsidiary which has a manufacturing plant in England to make anything, condiments, if you will. It sells all its condiments that it sells on the Continent first to a U.S.-controlled Swiss sales corporation. They never go to Switzerland, but they are marketed in France, Germany, Belgium, everywhere else as the property of the Swiss sales corporation. The entire profit is lodged in Switzerland. The manufacturing company in Great Britain is paid a very small figure for the wholesale value and makes a minor profit.

That is the type of operation that clearly is a tax haven operation.

Senator CURTIS. Where does the U.S. Government come into the transaction you described?

Secretary DILLON. Where the United States comes in, in that transaction, is that these would be controlled foreign corporations the control of which is in the U.S. parent corporation.[17]

The complexities of transferring available funds from developed nations to investments in less developed countries will frustrate our

[17] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., H.R. 10650, pt. 10, pp. 4309-4310.

foreign policy objectives of encouraging private investment to assume a larger role in economic development—thus relieving the taxpayers of a portion of this burden.

The Secretary of the Treasury in his appearance before the Finance Committee on April 2 expressed the view that tax haven operations constitute a serious abuse, and he urged the committee to amend the bill as passed by the House of Representatives to completely eliminate tax deferral on the undistributed foreign income of U.S. subsidiaries operating abroad. Shortly thereafter, the Secretary addressed the Ninth Annual Monetary Conference of the American Bankers Association in Rome, Italy, on Friday, May 18. He expressed a somewhat different view as to the nature of American oversea investments in his discussion of this subject before a foreign audience. He stated:

> The United States has consistently favored free capital movement the ability of individuals or companies to invest their funds where they will. There has been no change in that view. We are, however, asking our Congress to end the tax inducements to American investment in other industrialized countries, particularly the inducements which flow from the mushrooming use of so-called tax havens. The object is not to discourage capital from going abroad in search of higher gross return. That sort of investment will, in the long run, serve the investor, the United States, and the recipient country alike. We recognize that the great bulk of our foreign investment is of this type and is not tax induced. We do, however, want to make sure that our tax system does not unwittingly—and artificially—spur this outflow. We wish only to eliminate marginal foreign investment that is induced primarily by tax considerations. While there is no expectation that such action will dramatically reduce the outflow of direct investment funds from the United States, it will be of some help—and every bit counts in the effort to eliminate our payments deficit.[18]

The Secretary's statement shows that there is no need to risk the adverse effects that the passage of this legislation might entail, since he finds that the great bulk of our foreign investments is not tax induced and in the long run serves the investor, the United States, and the recipient country alike.

If the only concern of the Congress is to eliminate marginal foreign investment that is induced primarily by a tax consideration, then section 11 does not appear as an appropriate instrument to accomplish this end. Furthermore, the Secretary of the Treasury is on record at Rome that there is no expectation that the enactment of additional legislation will dramatically reduce the outflow of direct investment funds from the United States.

CONSTITUTIONALITY

Section 11 imposes a tax on U.S. shareholders of foreign corporations based on the earnings of such corporations even though there has been no constructive receipt of funds with which to pay the tax.

[18] Remarks of the Honorable Douglas Dillon, Secretary of the Treasury, Ninth Annual Monetary Conference of the American Bankers Association, Rome, Italy, May 18, 1962, p. 10.

The establishment of tax liabilities in this manner is a reversal of existing concepts which have been established for almost 50 years. It completely disregards corporate legal entities wholly legitimate in their business purposes.

The proponents of this theory of taxation attempt to justify it under the philosophy of the foreign personal holding company provisions. A colloquy between the Secretary of the Treasury, Mr. Dillon, and Senator Curtis of Nebraska is significant:

> Secretary DILLON. Under the philosophy of the foreign personal holding company provisions, the Congress has decided and the courts have upheld that where transactions are entered into for the purpose of avoiding U.S. taxes, the income can be imputed to the U.S. stockholders and that in effect is what is happening here.
>
> Senator CURTIS. That is a personal holding company?
>
> Secretary DILLON. That is what it is by definition.
>
> Senator CURTIS. I thought you were describing an actual operation of manufacturing and sale of goods throughout Europe.
>
> Secretary DILLON. There is no legal constitutional difference and we are following the exact same procedure here. We apply the same procedure to these other operations as has been applied for many years to foreign personal holding companies.
>
> Senator CURTIS. But suppose that the parent company in the United States is a publicly held corporation and not at all in the category of a personal holding company, and it has many stockholders, is income either to the—is income to the subsidiary income to the stockholders of the parent corporation.
>
> Secretary DILLON. We look on a parent corporation as a U.S. person under the law, and the income is imputed to the U.S. person who controls the foreign subsidiary, and that person would be the U.S. parent corporation.
>
> Senator CURTIS. Now suppose this company in this hypothetical case you describe was set up for the purpose not of evading taxes on income earned under the American flag but was for the purpose of finding a market, developing a market that could not be developed by the parent company located in the United States.
>
> Would that change the situation?
>
> Secretary DILLON. I certainly recognize that there are markets that can best be developed by investment abroad. But we do not feel that it is necessary to have as an added inducement and an added factor in that development the tax inducement of partial or complete tax exemption that flows from the use of tax havens. We think that the same markets could be developed by paying a reasonable tax.
>
> Senator CURTIS. They do pay a tax when the money is brought back, do they not?
>
> Secretary DILLON. A tax is paid when the money is repatriated to the United States; that is correct.
>
> Senator CURTIS. Now, speaking of operating companies that actually engaged in manufacturing, processing, selling,

all of that activity is outside the United States, isn't it true that heretofore we have adhered to a jurisdictional principle that a tax so earned outside of the United States—the U.S. tax on income earned outside the United States—is due when it is remitted to this country?

Secretary DILLON. That has been the principle in the law, except for the foreign personal holding company law.

Senator CURTIS. And this proposal would greatly change that wouldn't it?

Secretary DILLON. This proposal would very considerably modify that principle. That is the purpose of it.

Senator CURTIS. Now, you referred a moment ago to suggestions made yesterday to grant to the Treasury Department authority to by regulation—although you didn't use that word—except certain transactions or make a finding that they were not tax-haven transactions?

Now——

Secretary DILLON. That is correct.

Senator CURTIS. How is the business concern going to know what the rule of the Treasury would be 5 years from now?

Secretary DILLON. By coming in and asking.

Senator CURTIS. When? Now?

Secretary DILLON. Now.

Senator CURTIS. Would that answer be binding upon the Treasury 5 years from now?

Secretary DILLON. We would be prepared to give rulings on this sort of thing very generously ahead of time because we do not want to upset business and we don't want to have uncertainty here. We would be very glad for any business that thought it had a case to come in and talk to the Internal Revenue and we would give them a ruling in a proper situation.

Senator CURTIS. Well, I am glad you share the view that this is a decided change in the tax policy of the country.

One of the things I had in mind late yesterday afternoon when I requested that a new bill be drafted and printed as a study bill, study copy, was so that it could be examined, and to see what the proposal is made in our basic tax philosophy and practice in the light of your modified recommendations of your statement yesterday.[19]

It is inconceivable that the Secretary of the Treasury would suggest that exceptions to the law should be made on the basis of Treasury rulings so as not to disturb legitimate transactions.

The Foreign Personal Holding Company Act deals with passive investments that have no connection with the carrying on of an active trade or business.

The personal holding company tax was never conceived by the Congress as being applicable to the unremitted earnings of active overseas subsidiaries of U.S. business firms with widespread stockholdings.

---

[19] "Revenue Act of 1962," hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess. on H.R. 10650, pt. 10, pp. 4311-4312.

The National Foreign Trade Council was organized in 1914 to promote and protect American trade and investment. Its membership is comprised of manufacturers, merchants, exporters, importers, transportation interests, bankers, insurance underwriters, and many others interested in the expansion of the Nation's foreign commerce.

Mr. Joseph B. Brady, vice president of the National Foreign Trade Council, presented an extended legal brief to the House Committee on Ways and Means on June 5, 1961. It showed that the characterization of tax deferral as a privilege is a misleading one. It developed the history underlying the present U.S. tax laws, and it showed that the proposal to tax unremitted earnings is completely contrary to our established tax policies. It presents a serious question of the constitutionality of the administration's foreign tax proposals.

Section 13 of H.R. 10650 as it was referred to the Committee on Finance was based on the concepts to which the National Foreign Trade Council took exception in June of 1961. This organization again appeared before the Committee on Finance on April 25, 1962, and Mr. Brady again presented the legal reasons for the rejection of section 13 in the House measure. This section has been amended by the Committee on Finance and is now section 11 of H.R. 10650 as amended. The amendments adopted by the committee do not alter the underlying principles with respect to the taxation of unremitted earnings nor do they remove the constitutional doubts which were raised in the original brief presented to the House Ways and Means Committee. The legal reasons to reject any proposal to tax U.S. shareholders on the undistributed profits of foreign corporations contained in the statement presented to the Committee on Finance by Mr. Brady are worthy of the considered judgment of the Senate in its further deliberation on section 11 of H.R. 10650. These salient points with respect to legal and constitutional questions of this proposal follow:

> The legal reasons for rejecting the proposal to tax to the U.S. shareholder undistributed profits of foreign corporations, as provided by section 13, are discussed below.
>
> (a) *History and reasons for present law*
>
> The basic provisions of U.S. law, relating to taxation of income from foreign sources, have been in existence for nearly 50 years. All U.S. foreign investments have been made with these provisions as a background. In addition, important foreign investments have been made, under an announced policy of the U.S. Government, to encourage such investment.
>
> Under the 1913 act, income received by foreign corporations from sources outside the United States are not taxed. U.S. shareholders were taxed only on the dividends from such corporations. These basic provisions have been retained in all subsequent reenactments of the income tax law, including the 1939 and 1954 versions. Contrary to the impressions of some persons, no provisions were introduced into U.S. tax law after World War II to encourage investment and trade in Europe by U.S. companies.
>
> Like most features of tax law, these provisions reflect both theoretical and practical considerations. These considera-

tions generally fall either within the fiscal area, or the combined area, of public policy and trade. The recognition of the importance of foreign trade and investment, a recognition that income from foreign source is initially subject to tax in the foreign country, and the need for revenue, all form a part of the background for the enactment of our tax laws on income from foreign trade and investment.

The concept that a corporation is an entity, separate from its shareholders, has always been recognized as a fundamental in every phase of the law. The principle of the nontaxability of the shareholder on the undistributed income of a corporation has been one of the pillars on which our tax system has been constructed. In addition, considerations of international law and comity, as well as U.S. constitutional and administrative problems, are among the wide variety of factors that have affected the formulation of the basic U.S. tax provisions.

(*b*) *Proposal is contrary to basic U.S. tax policy*

It is a fundamental principle of all aspects of American and international law that a corporation is regarded as an entity separate from its shareholders. Thus the shareholder is not obligated by the contract of the corporation, and is not responsible for its wrongful acts. This principle has been incorporated in the Federal income tax law. A corporation is taxed on its income, and the shareholders are taxed only on dividends distributed to them. Any proposal to tax the U.S. shareholders on the income of the corporation would be an exception to this basic principle, which has been followed consistently by Congress, the Treasury Department, and the Supreme Court. The basic principle has been reflected in U.S. tax treaties and in the claims of tax jurisdiction which the United States has made in the absence of tax treaties.

Both in the domestic and foreign field, taxpayers are only subject to tax on income actually realized. Corporations and individuals owning shares of stock are not taxable because of accumulated earnings of the companies issuing the shares, nor are they taxable in respect of increases in the quoted market prices of those shares. Holders of corporate securities are not entitled to deduct, from their taxable income, any decreases in quoted market price or generally any operating losses of the companies which may dissipate their surplus or even impair their capital. The U.S. income tax system recognizes fully the corporate entity. A U.S. parent corporation is taxed upon the dollar dividend received from a foreign subsidiary, because that is the correct measure of its realized income.

The principle that income must be realized before it is taxable has frequently been upheld by the Supreme Court. In 1918, the Supreme Court drew a distinction between corporate accumulations and distributions, treating only the latter as taxable income. The Court stated: "It is evident that Congress intended to draw, and did draw, a distinction between a stockholder's undivided share or interest in the gains and profits of a corporation, prior to the declaration of a dividend, and his participation in the dividends declared and paid; treating the latter in ordinary circumstances, as a part of his income for the purpose of the surtax, and not regarding the former as taxable income unless fraudulently accumulated for the purpose of evading the tax." (*Lynch* v. *Hornby* (247 U.S. 339 at p. 343)). The fact that income must be "realized" is clearly set forth in *Eisner* v. *Macomber* (252 U.S. 189, 40 Sup. Ct. 189 (1920)) and has never been reversed.

The Treasury Department has followed the concept that income must be realized in order to be taxable; e.g., Regulations 1.61-1 provides in part: Gross income includes income *realized* in any form. [Italic added.]

Furthermore, the treatment of a foreign corporation as an entity, distinct from its shareholders, is recognized as a fundamental principle in 21 tax treaties, affecting some 44 foreign jurisdictions, to which the United States is a party. Even in the absence of tax treaties, the United States has recognized the foreign corporation as a separate entity and has never claimed tax jurisdiction over them, because it was owned in whole or in part by U.S. shareholders.

Since the enactment of the 1913 act, the United States has claimed jurisdiction to tax on the basis of (1) citizenship and residence, and (2) source of income in the United States.

To expand this jurisdictional claim, so as to tax, directly, the income of foreign corporations, because of American ownership of shares in such corporations, would run counter to all U.S. jurisdictional claims and might well bring about conflicts with the jurisdictional claims of foreign governments. It is undesirable, if not improper, for the United States to tax foreign corporations directly on their foreign income. These same considerations should apply to taxing the foreign corporation indirectly by taxing the shareholders.

The jurisdictional claims of the United States reflect the recognition that other sovereign nations have rightful claims to the primary jurisdiction of income earned by their corporations in their home country and in all countries other than the United States. The jurisdictional concepts of the United States are formally reflected in tax treaties between the United States and foreign countries which are discussed below.

The Secretary's explanation of his proposal states that "precedent for this tax treatment may be found in the provisions of existing law dealing with U.S. shareholders of foreign personal holding companies." These provisions are not an adequate precedent for such a broad departure from established tax policy. The provisions were enacted on the assumption that foreign personal holding companies were "created with the sole purpose of avoiding or evading the imposition of the surtax on their shareholders" and the legislation was intended "to encourage the prompt dissolution of existing companies of this type," which were regarded as "spurious" (report of the Joint Committee on Tax Evasion and Avoidance, Aug. 5, 1937, 75th Cong., 1st sess., H. Doc. 337, pp. 21 and 22). However, these provisions were never intended to, and do not, by the definition of foreign personal holding companies in the Internal Revenue Code, affect bona fide foreign business companies.

The foreign personal holding company provisions are strictly limited to the case where the foreign company is controlled by not more than five U.S. citizens or residents and derives 50 percent or more of its gross income from certain categories of income, such as dividends, interest, and capital gains (secs. 551–557, I.R.C.). The proposed recommendation by the Secretary is addressed to a situation which is quite different from that of the foreign personal holding company. With relatively few exceptions the foreign subsidiaries which will be affected are operating companies that would not be within the purview of the foreign personal holding company provisions. These foreign corporations have not been "created with the sole purpose of avoiding or evading the imposition of (a tax) on their shareholders." Rather these subsidiaries were formed to carry on U.S. trade and business in a part of the world most important from the viewpoint of national as well as business considerations. Further, it is not believed that "the prompt dissolution of existing companies of this type" is intended even by the Treasury. Therefore, it is urged that the foreign personal holding company provisions should not be regarded as precedent for the proposed legislation. An additional point which should be considered is that the foreign personal holding company provisions are primarily an extension to foreign companies of a punitive provision which previously was in effect domestically; namely, the personal holding company provisions.

The proposal to tax a shareholder on unrealized profits is, in effect, taxation by indirection of the current earnings of the foreign corporation and is designed to tax indirectly what could not be taxed directly. This policy of taxing by indirection is at least questionable from the standpoint not only of domestic tax policy but also of international comity. Probably any attempt by the United States to tax directly or indirectly foreign corporations on income not earned in the United States would be objected to by foreign countries. In the past, foreign countries have objected to the extraterritorial effect of other U.S. laws, for example, the extension of the antitrust and export control laws.

The proposals of the Secretary to impose taxes on U.S. shareholders of foreign corporations measured by the earnings of the foreign corporations as they accrue will result in a nullification of tax incentive programs designed by foreign countries to attract investment and reinvestment by foreign corporations. It would defeat the purpose of provisions under foreign tax laws, such as investment allowances, accelerated depreciation, and tax exemptions designed to promote economic development in the foreign country. It would also ignore requirements of the foreign country that legal and statutory reserves be set aside before dividends can be paid. It would be contrary to the practice in some countries which impose through private agreement restrictions on dividend distributions.

Foreign competitors of U.S. business would still enjoy the benefit of these incentives. Where American investments are an important factor the foreign country might revise its incentives program, and attempt to bring its tax rates up as high as 52 percent in order that it may obtain taxes which otherwise would redound to the benefit of the United States.

The proposal will have an adverse effect both on the corporations and shareholders. In many instances, shareholders may not have funds available from other sources to pay the taxes. This, of course, will place pressure on the foreign corporation to remit income to pay such taxes. Where local nationals are also shareholders and have a controlling voice in the company this pressure to distribute funds which otherwise would not be distributed in order to pay U.S. tax will be resisted. From a long-range point of view, it may deter local participation in companies in which American capital is invested. Furthermore, the individual shareholder who in most instances would have no control over the foreign corportation whatsoever could receive no foreign tax credit and would be required to pay such income tax out of his capital. Many foreign incorporated subsidiaries have incurred long-term financial commitments on the reasonable assumption that neither the subsidiary nor the shareholder would be subject to U.S. tax on the undistributed income of such subsidiaries. The proposed imposition of U.S. tax on U.S. shareholders might affect drastically the ability of the subsidiary to meet the financial obligations.

The proposal to tax the U.S. shareholder of a foreign corporation on the undistributed income of such corporation is contrarty to basic tax principles which have been followed since 1913. A departure from these principles would constitute a drastic change in this fundamental area of tax policy. It would constitute a deviation from the recognition of the separate entity of the corporation without which concept it would be impossible to conduct much of modern business. It would raise serious questions in the international field. Possibly one of the most important questions that should be considered would be the precedent that enactment of such proposal might constitute for taxing U.S. shareholders on the undistributed income of U.S. corporations.

(c) *Constitutionality*

Under the proposal, American shareholders of foreign corporations would be taxed on their share of the income of those corporations, even though it is not distributed. It has been held to be a violation of the due process clause of the 14th amendment to the Constitution for a state to measure the tax on one person's income by the income of another. *Hoeper* v. *Tax Commission* ((1931) 284 U.S. 206). It would seem equally a violation of the due pro-

> cess clause of the 5th amendment for the Federal Government to measure the proposed tax on the American shareholder by the income of another person, the foreign corporation.
>
> Under the 16th amendment Congress may tax incomes, from whatever source derived, without apportionment. It should be noted, however, that the 16th amendment is applicable only to true income taxes and that a tax cannot be brought within the scope of that amendment merely by calling it an income tax.
>
> *Eisner* v. *Macomber* ((1920) 252 U.S. 189, 206), held that income consists not in a growth or increment in value of an investment, but something of exchangeable value proceeding from the property, severed from the capital and coming into, or received by, the taxpayer, and that a stock dividend was not income within that definition because it did not accomplish an actual distribution of corporate earnings. The Court refused (p. 214) to "indulge the fiction" that the stockholders "have received and realized a share of the profits of the company which in truth they have neither received nor realized" and held that the corporation must be treated as a substantial entity separate from the stockholder. It went on to say that "enrichment through increases in value of capital investment is not income in any proper meaning of the term" and (p. 217) that to tax the shareholders upon their property interest in the stock of the corporation would be taxation of property because of ownership, and would require apportionment under article I of the Constitution. The Court expressly stated (p. 219) that "what is called the stockholder's share in the accumulated profits of the company is capital, not income." It follows from the holding in this case that the proposed tax on American shareholders of foreign corporations, measured by their shares of the undistributed income of those corporations, which they have not received as dividends, would be a direct tax on the shareholders because of ownership of shares and would not be a tax on income within the meaning of the 16th amendment. Under article I of the Constitution direct taxes must be apportioned among the States according to population. In *Pollock* v. *Farmer's Loan & Trust Co.* ((1895) 158 U.S. 601) it was held that taxes on personal property, or on the income of personal property, are direct taxes.[20]

An eminent student of taxation, Dr. Dan Throop Smith, professor of finance at the Harvard Graduate School of Business Administration and a former Assistant Secretary of the Treasury, in his appearance before the Committee on Finance on April 27, in referring to section 13 [21] of the act H.R. 10650 as passed by the House said:

> Section 13, I believe, is extremely bad. It seems to be based on a misconception, in fact on several misconceptions. The attempt to extend our tax jurisdiction over the undistributed income of foreign operating subsidiaries is, I submit, unsound in principle, extremely difficult in application, and

[20] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., on H.R. 10650, pt. 6, pp. 2086-2093.

[21] Sec. 13 was amended and is now sec. 11.

very much against the longrun national interest if the United States is to participate freely in the world's trade and income.[22]

Further problems involving our treaty obligations are presented in section 11. While the language technically does not violate our tax treaties, the consequences of the enactment of the legislation would definitely be contrary to the spirit and intent of these treaties and conventions. Again, the effect of these considerations was set forth by Mr. Brady, and the pertinent portions of this statement follow:

The proposal to tax *shareholders* on the undistributed income of foreign incorporated companies which is earned outside of the United States is a principle which has no counterpart in the tax systems of the major industrialized countries of the world. An analysis by local fiscal experts of the tax systems of Australia, Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Norway, Sweden, and the United Kingdom indicates that none of them applies such a principle. In 1939 the German Government enacted a provision under which a foreign subsidiary which is dominated by a German company may be regarded as resident in Germany and taxed on all its income. Such tax would be imposed on the subsidiary and not on the shareholder. It is understood that this provision has been rarely applied in the past and that it is not anticipated that it will be enforced in the future. The United Kingdom and Japan also have in exceptional cases treated a foreign corporation as a resident for tax purposes if its mind and management are within the country, but this means that the corporation itself becomes liable for tax and not its shareholders. Under present practice the mind and management of a company will not be located in the country if the administrative office, directors' meetings and general managerial functions are conducted outside the country.

The proposal attempts to expand the jurisdiction of the United States, beyond that normally considered by any other country, so as to tax the shareholder, solely by reason of his ownership on his share of the earnings of a foreign corporation before such earnings are distributed. Inasmuch as such a policy, if adopted by United States, would add a new principle in the international tax field we do not believe that the Congress will wish to attempt to expand its taxing jurisdictions to such extremes.

In his appearance before the Committee on Ways and Means the Secretary of the Treasury stated in discussing the proposal to tax to the U.S. shareholder the undistributed income of foreign corporations:

"This method of taxing would eliminate possible conflicts with U.S. treaty obligations, which might occur if the tax were imposed directly on the income of foreign corporations."

He considers that treaty obligations would not be violated if the domestic shareholders were required to "include in gross income each year that portion of the undistributed

[22] Ibid., pp. 3088-3089.

earnings and profits of the foreign corporation which they would have included in gross income had the foreign corporation distributed its entire profits for the year." Nevertheless, the tax is levied on the basis of income that belongs to the foreign corporation and not to the shareholders.

Treaties are founded on respect by one party for the laws of the other, except insofar as the treaty limits their respective jurisdiction to avoid double taxation. They respect the principle that the corporations of the other country may conduct their affairs in accordance with the laws of the other contracting party. Treaties are founded on reciprocity and if the United States invades in effect the jurisdiction of the other party to levy a tax, even if it collects the tax from its own resident shareholders, the United States could not object if the other foreign government levied a reciprocal tax based on the undistributed income of U.S. corporations. This initiation on a wholesale basis of extraterritorial taxation of the type could seriously damage international investment and business relations conducted through subsidiaries and would certainly violate the intent, spirit and basic principles of the 21 tax treaties which are in effect vis-a-vis some 44 foreign governments.

The principle that a tax can be levied generally on the basis of a foreign corporation's income or a portion thereof, but collected from the shareholder is absolutely contrary to long-established principles of international tax treaty law as well as American jurisprudence. It has been argued that, under the treaties, the United States, in determining its taxes in the case of its citizens, residents or corporations, may regardless of any other provision of the treaties, include in the basis upon which such taxes are imposed all items of income taxable under the revenue laws of the United States as if the treaties had not come into effect. This is the so-called saving clause. However, the doctrine of *Eisner* v. *Macomber*, that the income tax is imposed on realized income, pervaded at the time of entering into the treaties and since that time in U.S. tax law. This doctrine must be considered as reflected in the meaning of the treaty provisions. The saving clause should therefore be read to refer only to items of realized income, including dividends from a corporation of the treaty country, and not to unrealized income.

Our first tax treaty was entered into with France. The primary objective of the treaty was to prevail upon France to give up its tax on dividends distributed by U.S. corporations which were deemed to be paid out of income from French sources. Because of this tax the United States adopted the provision for a retaliatory tax against discriminatory or extraterritorial taxation now found in section 891, I.R.C. The French agreed to waive their extraterritorial dividend tax in consideration of a treaty provision authorizing the French Government to collect tax from the French company on any income shown to have been diverted from it to an American corporation. However, when this convention with France and each subsequent convention was negotiated, no other country sought to tax shareholders resident in its territory on undistributed income of a foreign corporation because of control or ownership.

It will be observed that the United States reacted sharply to an extraterritorial imposition of tax by France. In effect the Treasury proposal would tax income of foreign corporations derived from foreign sources. The treaties specifically limit the jurisdiction of the United States over a foreign corporation to income from sources within the United States, and therefore the United States is obligated not to tax the income of a foreign corporation from sources without the United States. Would it be too much to expect that foreign countries in general, and treaty countries in particular, would react sharply by similar retaliatory taxes to U.S. taxation of the income of their corporations before it is paid out in dividends?

Congress has, through the enactment of two provisions in the code, clearly expressed its policy to be against the violation of tax treaty obligations. Section 894 requires that income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from tax under this subtitle. This should include the foreign income of a foreign corporation to the extent it is not distributed to U.S. shareholders.

Section 7852(d) provides that no provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title, and respect for international comity would require a similar provision be incorporated in any future tax legislation with international implications.

There is another provision in a number of tax conventions and executive agreements that would also be violated by the proposed amendment; namely, the provision for exemption from U.S. tax, on condition of reciprocity, of income derived in the United States from the operation of ships and aircraft which provides that such income shall not be included in the gross income of a foreign corporation and shall be exempt from taxation. Yet, if the foreign corportion which benefits from this exemption happened to be within a developed country or to be classified as a tax-haven corporation, the recommendation would tax the income that is thus not includible in the gross income of the foreign corportion.

The Supreme Court has declared: "The principles which should control the diplomatic relations of nations and the good faith of treaties as well, require that their obligations should be liberally construed so as to effect the apparent intention of the parties to secure equality and reciprocity between them" (*Jordan* v. *Tashiro*, 278 U.S. 123). Obviously, all our tax treaties were concluded with reference to to the United States and foreign laws in effect when the treaties were negotiated, and it was not contemplated that the United States might someday tax U.S. shareholders on

> the profits of foreign corporations before they are distributed. This, it is believed, violates the spirit and intent of tax treaties.[23]

The many amendments adopted during the course of the committee's consideration of this measure do not alter the basic principles of levying a tax on U.S. shareholders of so-called "controlled foreign corporations" based on their unremitted earnings.

The amendments adopted by the committee have lessened the impact of the added tax burden, but they do not deal with the fundamental problem of a basic change in the concepts which have guided the Congress for almost 50 years in the enactment of all tax legislation.

Should section 11 be enacted into law, retaliatory measures may be adopted in other countries. In any event, it will most probably be difficult to negotiate new tax treaties that further the commerce and interests of our Government and its citizens.

SUMMARY AND CONCLUSIONS

These views have set forth the many reasons why the objectives the administration seeks cannot be achieved through the enactment of section 11 of H.R. 10650 as reported by the Committee on Finance. The objectives are desirable, but the means that have been recommended for their accomplishment are impractical and unworkable.

The administration has long been on record that it will recommend additional basic reforms in our tax structure for the consideration of the Congress next year to become effective January 1, 1963.

Section 11 of H.R. 10650 also provides that it shall be effective with respect to the taxable years beginning after December 31, 1962. It thus appears that if section 11 were enacted into law by the 87th Congress, the Secretary of the Treasury would have only 4 months in which to establish the rules and regulations for its implementation. Of necessity rulings would conform to the present basic tax laws. If the 88th Congress enacts a broad program of tax reform, then it will be necessary for the Secretary of the Treasury to redraft completely the rules promulgated under section 11 of the pending bill to make it conform to a new tax code which also will be effective January 1, 1963. Such a procedure will entail expense and difficulties for the Internal Revenue Service to say nothing of the confusion and cost of compliance that will confront taxpayers.

It would appear that the Internal Revenue Service should concentrate on more effective enforcement of existing law rather than apply itself to the promulgation of rules and regulations which will require revision within a matter of months.

When the Congress considers the broad issues of tax reform, it should give consideration to necessary amendments to existing law to prevent evasion and simplify the burden of reporting for both the taxpayers and the Internal Revenue Service on all phases of foreign source income.

The administration's objections will not be achieved by the enactment of section 11 of the bill as reported by the Committee on Finance at this time. The testimony that has been considered by both the House Ways and Means Committee and the Committee on Finance

[23] Ibid., pp. 2694-2698.

during the 87th Congress should supply information that will be of assistance to the administration and the Congress in developing a workable program for the collection of proper taxes on foreign investments without establishing practices which may be unconstitutional, as they impose taxes on earnings that have not been constructively received by the taxpayer. The enactment of section 11 at this time can only result in years of costly litigation. Many taxpayers will not know their true tax liabilities, and the Treasury will be unable to properly estimate the tax revenues to which it is entitled until the Supreme Court has interpreted this legislation.

The only recommendation that can be made to the Senate on the basis of a careful and deliberate consideration of the entire record is to postpone action on section 11 and reconsider this entire subject in conjunction with the administration's basic tax reform program when it is presented to the 88th Congress.

FRANK CARLSON.
WALLACE F. BENNETT.
JOHN MARSHALL BUTLER.
CARL T. CURTIS.
THRUSTON B. MORTON.

SUPPLEMENTAL AND MINORITY VIEWS OF SENATORS PAUL DOUGLAS AND ALBERT GORE

INTRODUCTION

When the administration proposed this bill a year and a half ago, it was intended to close a few of the loopholes which disgrace our tax system and cause grave injustices and irregularities in the application of our tax laws. The total amount of revenue which would have been saved to the Treasury and hence to the people was, by the terms of the President's original proposal, approximately $2.3 billion. A brief description of these reforms and the amounts expected to be realized during the first full year of their operation will be found in the first two columns of table I.

To "sweeten" the proposals for tax reform and make them more acceptable to those who had been avoiding the just payment of taxes on certain income in the past, a tax reduction was offered consisting of a generous tax credit on most forms of net business investment in depreciable property. It was estimated that on an annual basis, this would lose $1.7 billion in revenue.

The original plans of the administration thus provided for an overall annual increase in revenues of about $600 million. But it is probably fair to conclude that knowing the tendency for tax reform proposals to be whittled away and indeed to evaporate as they move through Congress, the administration really would have been satisfied if the "loophole" closing and the investment credit finally offset each other so that there would have been little or no net revenue gain or loss. The basic orginal aim of the bill was therefore (1) to effect minor and, it was believed, less controversial changes in the field of tax reform, and (2) to balance this with an approximately equal reduction in the taxes paid by business and industry. This latter was framed in such a way that it was hoped it would stimulate new investment and the modernization of machinery and equipment.

In the long-drawn-out process of nearly a year and a half during which this bill has moved slowly through the other body and through the Finance Committee, it has been disfigured almost beyond recognition.

The proposal to repeal the 1954 dividend credit of 4 percent and exclusion of $50 which would have reclaimed $450 million a year for the Treasury and the people was thrown overboard early.

The main feature on the loophole closing side, namely, the withholding at the source on dividends and interest income paid by institutions, was eliminated by a lopsided vote in our committee. It is estimated that, in itself, this would lose about $900 million in revenues from taxes which are owed but not paid. This step was taken by the committee to the accompaniment of a tornado of mail stimulated by building and loan associations, banks, and savings institutions. One of the signers of this minority report received no less than 75,000 letters from his constituents demanding that withholding be eliminated from the bill. These letters portrayed gross misconceptions of what the withholding method really was. Thus, (1) from a third to a half of the correspondents thought that it was a new tax; of course, it was no such thing. Interest and dividends are income just as much as wages and salaries and as such are equally taxable. The fact that so many thought it would be a new tax strongly suggests that many of these people have not been paying these taxes in the past. (2) It was charged that this was a tax on capital, whereas it would only be a method to collect the tax already owed on the interest or dividend income earned. (3) The administrative difficulties as we shall see were also grossly exaggerated.

Under heavy battering from American corporations doing business abroad, the proposed levies on them based on earnings of their foreign subsidiaries were progressively softened.

On the other side of the balance sheet there was some reduction in the amounts granted for the investment credit. But the overall result is that, if the present bill is enacted, there will be a net revenue loss of at least $550 million, and, in our judgment, nearer $700 million a year.

What was originally a bill in which the revenue losses would at least be balanced by the revenue gains has now become a bill in which the revenue losses greatly exceed the revenue gains.

What was originally a bill in which a few of the most glaring and, on the whole, less controversial loopholes were to be closed has, in its present form, turned into a bill in which a few minor loopholes are closed but in which some new major loopholes and truckholes are opened.

What was originally a bill to stimulate new marginal net investment has now become a bill in which a tax favor is granted even for less investment than in the past.

What was originally a bill to close some of the most glaring loopholes with respect to business expense account deductions has now become a bill in which business groups will be given new deductions for lobbying on behalf of their own selfish interests.

In other words, in its present form, what was on balance a tax loophole closing bill has, on balance, become a tax loophole opening bill.

Unless major changes are made in this bill either on the floor of the Senate or in conference, we must vote against it.

TABLE I.—*Evolution of the Revenue Act of 1962—with pertinent revenue estimates* [1]

LOOPHOLE CLOSERS

President's proposals of Apr. 20, 1960	Revenue gain	House bill	Revenue gain	Revenue decrease compared to President's proposal	Finance Committee bill	Revenue gain	Revenue decrease compared to House bill	Revenue decrease compared to President's proposal
	Millions		*Millions*	*Millions*		*Millions*	*Millions*	*Millions*
Sec. 4. Expense accounts Provides 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, on travel expenses for vacations that are combined with business travel, and on excessive personal living expenses incurred on business travel away from home.	$250	Under the House bill expenditures for entertainment activities must be directly related to the active conduct of the taxpayer's trade or business and those for entertainment facilities such as yachts must meet an additional test of being primarily in furtherance of the trade or business. Deduction was denied for business gifts in excess of $25, a standard of "reasonableness" was added to the provisions dealing with traveling expenses, and a good rule requiring substantiation of expenditures was adopted.	$125	$125	The Finance Committee added to the directly related test of the House bill a liberalizing test permitting the deduction of entertainment expenditures if they are directly "associated with" the taxpayer's trade or business. In addition, the committee's report is very weak and confusing—quite unlike the report of the House Ways and Means Committee which provided some meaningful guidelines that made the House provision workable and effective.	$60	$65	$190
Sec. 6. Mutual savings banks The existing bad debt reserve formula of 12 percent of deposits, which has resulted in virtual tax exemption, would be reviewed to assure "nondiscriminatory treatment." The Treasury Department Report of July 1961 suggested alternative methods of taxation to produce revenue of between $150 to $416 million, at 1963 levels of income, depending upon alternative selected.	$150–416	Provided a bad debt reserve deduction of 3 percent of the increase in real estate mortgage loans or, alternatively, a deduction of 60 percent of retained earnings. Technical provisions changed definition of "domestic building and loan association," prevented capital stock savings and loan associations from distributing to stockholders pre-1952 tax-free surplus, removed certain exemptions from excise taxes, and applied realistic rules for computing bad debts resulting from mortgage foreclosures.	$200	----------	In the case of capital stock savings and loan associations, the special deduction of 60 percent of earnings was reduced to 50 percent to produce additional revenue of about $5 million annually. Other changes modified definition of domestic building and loan association, broadened repeal of excise tax exemptions, imposed ceilings on amount of reserves, and took into account tax-free surplus accumulated prior to 1952 to the extent necessary to place all institutions on an equal basis.	$205	+$5	----------

See footnotes at end of table, p. 395.

TABLE I.—*Evolution of the Revenue Act of 1962—with pertinent revenue estimates* [1]—Continued

LOOPHOLE CLOSERS

President's proposals of Apr. 20, 1960	Revenue gain	House bill	Revenue gain	Revenue decrease compared to President's proposal	Finance Committee bill	Revenue gain	Revenue decrease compared to House bill	Revenue decrease compared to President's proposal
	Millions		*Millions*	*Millions*		*Millions*	*Millions*	*Millions*
Sec. 8. Mutual insurance companies Provided for the elimination of the special provisions of existing law which are applicable only to mutual fire and casualty insurance companies, so as to tax such companies on total income in essentially the same manner as stock fire and casualty insurance companies.	$50	Provided a modified total income approach which permits a portion of underwriting income to be set aside tax free in a special reserve for protection against losses. Also, provided special rules for concentrated risk companies, reciprocals, factory mutuals, mutual marine companies, and certain small mutuals.	$40	$10	Changed the order in which losses are to be charged to the special protection against loss reserve. Other changes liberalized the provisions of the House bill relating to concentrated risk companies, reciprocals and certain small mutuals, and provided a special rule for taxing mutual flood insurance companies.	$35	$5	$15
Sec. 13. Gain on depreciable property Gain on sale of depreciable property, both real and personal, should be treated as ordinary income to extent of prior depreciation.	$200	Removed real estate from application of provision.	$100	$100	Same as House bill.	$100	$0	$100
Sec. 17. Cooperatives Provide that all earnings of a cooperative arising from business activities are taxable to either the cooperative or its patrons. The patrons (and not the cooperative) would pay the tax on patronage distributions in money or noncash allocations meeting certain conditions. The cooperative would be taxable on earnings which are not returned to the patrons.	$35	The Ways and Means Committee made several refinements in the bill, none of which affected the revenue estimate. The primary change requires the patron to consent to paying the tax on noncash distributions before he is taxable and the cooperative receives a deduction.	$35	$0	The Senate Finance Committee made 2 changes in the House bill, none of which affects the revenue estimate. One would require the cooperative to distribute at least 20 percent of its patronage dividends in cash in order to escape tax—this replaces the 20-percent withholding that would have been required under the House bill. The other change prescribes an alternative method for a patron to consent to paying tax on noncash distributions.	$35	$0	$0
Sec. 19. Withholding Provide for withholding of 20 percent from interest, dividends, and patronage dividends.	[2] $880	The Ways and Means Committee made several important refinements in the bill, but none of them affected the revenue estimate. The most important changes were the inclusion of exemptions for nontaxable persons and the extension of the quarterly refund procedures to taxable individuals who are subject to overwithholding.	Same	----------	The Senate Finance Committee deleted the withholding plan and substituted an expanded information reporting plan under which all dividend, interest, or patronage dividend payments of $10 or more a year must be reported to the Government, with a copy of the information given to the payee.	[1] $275	[3] $605	[3] $605

FOREIGN INCOME								
Sec. 12. Controlled foreign corporations Provide for the elimination of deferral of U.S. tax of foreign subsidiaries.	$230	The House bill would eliminate deferral with respect to certain tax haven profits, earnings not reinvested in an existing business in a developed area or in an active business in a less developed area and earnings reinvested in the United States in such a way as to constitute a constructive dividend. However, tax haven profits which were invested in less developed areas would not be covered.	$85	$145	The Senate Finance Committee restricted its approach to the elimination of deferral for tax haven profits and those earnings invested in the United States. It improved the taxation of tax haven profits by (*a*) including certain service income and branch sales profits, (*b*) excluding the profits of certain active businesses from the definition of tax haven profits, and (c) eliminating the "pour over" of developed-area tax haven profits into less developed countries. The committee also added 2 important exceptions for (*a*) the earnings of certain export trade corporations and (*b*) the earnings of certain foreign subsidiaries or groups of foreign subsidiaries which distributed specified minimum percentages of their after-tax earnings.	$85	$0	$145
Sec. 9. Gross-up Provide for "gross-up" of dividends received by U.S. companies from their foreign subsidiaries so as to correct the inadequacy of the existing foreign tax credit fromula under which the combined U.S. and foreign tax may be substantially lower than 52 percent. Under existing law, the disparity between 52 percent and the actual combined rate varies with the actual foreign taxes paid, being highest at 26 percent and gradually diminishing as the foreign tax drops below or rises above 26 percent.	$35	With the exception of a 2-year grace period for previously accumulated earnings, the Ways and Means Committee adopted the President's recommendation.	$35	$0	The Senate Finance Committee adopted the proposal only with respect to dividends received from operations in developed areas. The existing formula would continue to apply for dividends paid from less developed country earnings.	$25	$10	$10

See footnotes at end of table, p. 395.

TABLE I.—*Evolution of the Revenue Act of 1962—with pertinent revenue estimates* [1]—Continued

LOOPHOLE CLOSERS

President's proposals of Apr. 20, 1960	Revenue gain	House bill	Revenue gain	Revenue decrease compared to President's proposal	Finance Committee bill	Revenue gain	Revenue decrease compared to House bill	Revenue decrease compared to President's proposal
FOREIGN INCOME—continued	*Millions*		*Millions*	*Millions*		*Millions*	*Millions*	*Millions*
Secs. 5, 7, 10, 11, 14, 15, 16, 18, 20 and 27. All other foreign items. (For convenience, section references refer to section numbers in the Senate Finance Committee bill.) (1) Eliminate the tax-free nature of certain distributions by foreign trusts to U.S. beneficiaries (sec. 7). (2) Eliminate the exclusion of income for U.S. citizens residing in developed areas of the world and reduce it to $20,000 annually for those residing in less developed areas (sec. 11). (3) Eliminate the tax benefits now obtained by U.S. citizens through investments in foreign investment companies (sec. 14). (4) Eliminate the present exclusion of foreign real property from the gross estate of decedents subject to U.S. tax (sec 18). (5) Improve the information now required regarding U.S.-owned foreign corporations (sec. 20). [No recommendations similar to secs. 5, 10, 15, 16, or 27.]	$50	The Ways and Means Committee generally adopted the proposals regarding foreign trusts, foreign investment companies, foreign real estate and improved information requirements. As to the earned income exclusion, the committee provided that U.S. citizens residing abroad could annually exclude $20,000 for the first 3 years of foreign residence and $35,000 thereafter, without distinction between developed and less developed areas. The committee added provisions increasing the taxation of distributions in kind from foreign corporations (sec. 5), gain on the sale or exchange of stock in foreign corporations (sec. 15) and a provision regarding the relationship between the bill and existing tax treaties (sec. 27).	$30	$20	The Senate Finance Committee, at the recommendation of the Treasury, added a provision providing for a special computation of the foreign tax credit with respect to certain interest income designed to halt certain flows of capital abroad which are induced by the existing foreign tax credit mechanism (sec. 10) and also added a provision providing for the taxation of gain from the sale of certain patents and other intangible rights to foreign subsidiaries as ordinary income where such gain would otherwise be taxable as capital gain under existing law (sec. 16).	$30	$0	$20
Repeal of dividends received credit and exclusion Repeal of provision excluding first $50 of dividends and allowing a credit of 4 percent on dividends in excess of $50.	$450	Not included in bill.	$0	$450	Not included in bill.	$0	$0	$450

Sec. 2. Investment credit Investment in new real and personal depreciable property having a useful life of 6 years or more qualified for a credit of 15 percent to the extent the new investment exceeded current depreciation allowances. A 6-percent credit was allowable on new investment between 50 and 100 percent of current depreciation allowances, with a minimum credit of 10 percent on the first $5,000 of new investment. The credit was not to affect the depreciable cost of the property. Residential property, property used outside the United States, and property used by public utilities (other than transportation) were ineligible. The credit deductible in any one year was limited to 30 percent of tax liability, but the excess could be carried forward for 5 years. The proposed effective date was Jan. 1, 1961.	*Billions* $1.7	The House approved the tax credit plan, but made the following changes: (1) Eliminated the "excess approach" in favor of a 7-percent flat across-the-board credit; (2) Excluded all buildings and certain other real property, but made personal property of hotels and motels eligible; (3) Permitted $50,000 of used property to qualify; (4) Eliminated any limitation on the use of the credit on the taxpayer's first $25,000 of tax liability; adopted a 25-percent limitation on the tax liability above $25,000; (5) Approved a 3-percent credit for public utilities; (6) Dropped the useful life requirement to 4 years, but scaled down the benefits of the credit for assets with lives between 4 and 8 years; (7) Moved the effective date up to Jan. 1, 1962.	*Billions* $1.395	*Millions* $305	The Senate Finance Committee modified the House bill in the following manner: (1) Required that the credit be subtracted from the taxpayer's cost of the property before permitting the taxpayer to compute his depreciation allowance. (2) Disallowed a credit upon the investment of insurance proceeds, and upon the purchase of livestock. (3) Approved a 3-year carryback of unused credits, in addition to the 5-year carryover. (4) Moved the effective date up to July 1, 1962.	*Billions* $1.340	*Millions* $55	*Millions* $360
Sec. 3. Lobbying expenditures The President did not recommend that a deduction be allowed for lobbying expenditures and the Treasury Department is opposed to the allowance of any deductions in this area.	----------	The House bill permits business taxpayers to deduct the following lobbying expenditures: the cost of appearing before and communicating with 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 the carrying on of such activities by the organization.	(3)	----------	The Finance Committee expanded the House provision to cover the cost of sending lobbying material to employees and stockholders.	----------	(3)	----------

[1] All estimates in this table are those of the Treasury except for the investment credit as passed by the House and as passed by the Senate Finance Committee, and the revenue figures for reporting of dividends and interest, where the Joint Committee on Internal Revenue Taxation's figures are used.

[2] $670 million (based on 1959 data) $780 million based on 1960 data; $880 million for 1963 based on trends from previous years.

[3] No estimates available.

87490—62——26

THE INVESTMENT CREDIT—THE OPENING OF ANOTHER LOOPHOLE

I

WHAT THE INVESTMENT CREDIT IS

1. The bill in its present form provides a tax credit of 7 percent on amounts invested in new tangible depreciable property, other than buildings, which is subject to a depreciation life of more than 8 years. There are certain limitations which can be briefly stated: (*a*) If the life of the property is less than 4 years, no credit will be granted; (*b*) if the life is from 4 to 6 years, only one-third of the credit (2⅓ percent) will be granted; (*c*) if the life is from 6 to 8 years, then two-thirds of the credit (4⅔ percent) will be granted. The credit for used property is limited to the first $50,000 of investment.

2. The bill also provides a 3-percent credit for regulated private utilities such as telephone and domestic telegraph, gas and electric companies.

3. The investment credit can be offset dollar for dollar against taxes owed up to $25,000 but above that amount may not reduce tax liability by more than 25 percent.

4. The Long amendment adopted by the Finance Committee slightly reduces the effect of these tax credits in later years by providing that the basis cost of the asset shall not exceed the value of the asset minus the investment credit. Thus, depreciation is limited to 93 percent of the original cost of the asset (97 percent for utilities).

The Department of Commerce estimates that the production of durable equipment in 1961 amounted to $25.5 billion. A 7-percent reduction in this would amount to $1¾ billion annually. This would be reduced in practice by the lower rate for the private utilities, the exceptions listed above, and the Long amendment.

It is probably safe to estimate the initial loss of revenue from this feature of the bill at somewhere between $1.1 billion to $1.4 billion. We personally believe it will amount to not far from $1.3 billion.

This measure is advocated by the majority as a means of stimulating industry to improve its plant and machinery, reduce its costs, and by stimulating investment to expand employment and reduce unemployment.

Here it should be noted that the tax credit originally proposed by the administration was on net additional investment, or the amount invested in industry over and above that allowed for depreciation. There would have been strong grounds for supporting such a proposal or one which would have given the credit to increases in investment over the average for a previous 3- or 5-year period. But during its consideration by the House Ways and Means Committee, this proposal was vulgarized almost beyond recognition. Instead of being a bonus for net additional investment or for increased investment, it was transformed into a credit for all investment (aside from buildings) or what may be termed gross investment. Thus, if a company invests less than the physical depreciation of its machinery and equipment, it will still get a 7-percent credit, or a 14-percent tax deduction on this gross investment. To repeat, an actual decrease in investment as compared with the years prior to July 1, 1962, will be rewarded.

II

WOULD THE INVESTMENT CREDIT APPRECIABLY STIMULATE INVESTMENT?

In other words, by giving the rewards on average gross investment rather than on marginal net investment any possible stimulus to added investment is greatly reduced and in our judgment is very slight indeed. We are confirmed in this opinion by the results of the McGraw-Hill survey in the spring of 1962. The question asked by McGraw-Hill was as follows:

> If the administration's program of tax incentives for investment were enacted, how much would this increase your capital expenditures in 1962?

In reply to this, business as a whole indicated that it would raise its 1962 plans by only about 1 percent, or about $300 million. Nine out of every ten companies which replied stated that they would not use such a program in 1962.

Since the bonus under the proposed investment credit will amount to about $1.1 to $1.4 billion, this would mean that, out of every dollar which the Government will lose in taxes, less than 30 cents will find its way into increased investment in American industry. This is a very high price to pay for a little stimulus.

The National Industrial Conference Board made a special survey in late March and early April 1962 of the 1,000 largest manufacturing corporations in the United States to determine what effect the 7-percent investment credit would have upon their capital investment. While the influence of the credit on the plans of the companies varied somewhat from industry to industry, the results were that only 8 percent of those responding said they would revise their capital spending for the balance of 1962 if the credit were enacted by mid-1962. Seventeen percent of the reporting companies said they would increase their investments in 1963 if the credit were enacted by the end of the current session of Congress. But the prospective change in the dollar volume of capital spending in 1963 as a result of the credit would be as small as 1 percent.

As the report of the survey states:

> Overall, * * * the increase in 1963 outlays expected on account of the investment tax credit may be small in relation to its potential. In more than half of the industries covered, moreover, the imputed difference was less than 1 percent.[1]

There are already more than adequate funds available for investment on the part of corporations which they are refusing to use for this purpose. Thus the July 1962 Survey of Current Business, issued by the Department of Commerce (p. 24), shows that in 1961 American corporations had acquired $43.1 billion of corporate funds[2] but invested only $31.3 billion in equipment and inventories.[3] In this one year, therefore, they piled up nearly $12 billion in liquid assets.

---

1 The Business Record, National Industrial Conference Board, August 1962, p. 19.

2 Made up as follows (in billions of dollars): Retained profits, $7.3; depreciation, $24.8; sale of stocks, 4.5; sale of bonds, $5.1.

3 Made up of $29.6 billion in plant and equipment and $1.8 billion in inventories.

There were also very large accumulations of liquid assets in preceding years, amounting to about $5 billion in 1960 and an equal amount in 1959.[4] If business conditions did not cause American corporations to invest these huge sums in past years, there is little prospect that the extra bonus of $1.3 billion will be translated into investment. What is more likely to happen is that the overwhelming proportion will also pass into the cash reserves and swell them still further. There would seem to be little prospect that the investment credit will have any real stimulative effect. It will increase the power and wealth of the already powerful and wealthy.

We should also realize that a very large percentage of plant and equipment now lies idle and unutilized primarily because there is not adequate demand for the goods which could be produced at the prices charged.

The McGraw-Hill index of plant utilization is now at approximately 85 percent. Even though the 15 percent which now lies idle is partially composed of a "standby" reserve or is markedly obsolete, it is still true that the percentage of plant utilized is 5 or 6 percent short of what would be used under full employment. Can it be maintained that, if good machinery and equipment is thus allowed to lie idle because of a shortage in effective demand relative to prices, a bonus on investment would stimulate a still further increase in machinery and equipment? For would not this still further increase the already high percentage of idle equipment?

In addition, it should be realized that, while the purpose of the investment credit is to stimulate economic growth and to help business to compete more effectively in foreign markets, it would in fact be given all the way across the board without regard to the quality or social need for the investment. Thus, the credit would be available for such investments as a new ski-lift at Sun Valley or in Vermont, an escalator in a department store, new farm machinery to spread fertilizer on lands which are already overproducing, Klieg lights in a burlesque house, and martini-mixing machines in a bar. Other investments of an even more questionable nature would receive the bonus.

It is hard to see how this increases our efficiency as compared with other countries or whether this serves meaningful economic growth.

The 3-percent credit which is to go to utilities would be completely wasted and is wholly unnecessary.

The rate of return of the private utilities is regulated by both State and Federal bodies. If regulation is properly carried out, then any favorable tax consequences of the credit would be offset by reductions in the rates charged to consumers.

If not properly carried out, it would be an outright gift to the private utilities, for it would merely increase their rate of return above that set by the regulatory bodies.

In addition, the 3-percent credit for utilities has nothing to do with other stated purposes of the credit, namely, to help modernize industry or to make it more competitive in world markets.

[4] John K. Landrum seems to come to the same general conclusion, although with somewhat smaller increases in liquid funds. See his Corporate Profits and Cash Flow supplement to testimony before Joint Economic Committee, Aug. 10, 1962, p. 1.

III

WHO HAS BEEN GETTING THE TAX CUTS?

Let us also note the way in which tax benefits and reductions have been made during these last 8 years. In 1954, accelerated depreciation, with the double declining balance and the sum of the digits methods, was authorized by Congress. This amounted to an initial loss of revenue to the Government of at least $2 billion a year. This went to the industrial corporations and to the industrialists. At the same time the $50 dividend exclusion and the 4 percent credit were passed in 1954 which gave $400 million a year more to the owners of common stocks. This summer the Treasury has issued a new Bulletin F, permitting machinery and equipment to be depreciated much more rapidly. It is estimated that this will reduce business taxes by approximately $1.5 billion a year. All of these taken together come to just short of $4 billion a year.

Now we have this provision for the investment credit which will give the investors in machinery and equipment at least another $1.3 billion annually. Thus, in 8 years we have decreased the annual tax burden on industry by over $5 billion a year. This, of course, goes to the upper income groups in society who own the overwhelming proportion of the stock of American corporations.

During this period the low- and middle-income groups have received virtually nothing in the way of tax cuts. It is about time that the United States was less partial in its distribution of favors. This is true both on economic and ethical grounds.

IV

INVESTMENT CREDIT A FORM OF THE TRICKLE-DOWN THEORY

The basic way in which investment is stimulated and the economy moved forward is not by granting incentives for increased capital expenditures at a time when the existing plant and equipment is not fully used, but by increasing the demand for the products which the existing plant and equipment can produce which, in turn, will stimulate investment. In other words, the investment credit proposed is really a form of the trickle-down theory of economics which has largely been shown to be ineffective in the past. We believe instead in the theory that purchasing power should be built from the bottom up.

V

INVESTMENT CREDIT OPENS UP ANOTHER LOOPHOLE

Finally, the investment credit would open up more tax loopholes and would be quickly extended to other fields.

As nearly as possible a proper tax system should be neutral in the way it treats both income and expenditures. If we could have an absolutely just tax system it would probably make no distinctions as to the amount of tax to be paid on income or deductions for expenditures, no matter where the funds were derived or for what they were spent. It is the failure to carry out this principle which has so eroded our present tax system and which has made it so unjust.

For example, income from a wage or salary, in general, is taxed at the full rate, but income from oil, or from stock options, or from the cutting of timber, or from dividends, or from gains on the stock market, or from the sale of real property, among others, is taxed at lower rates and has special privileges not afforded to income from a wage or salary.

On the expenditure side, money spent for entertainment expenses, for business expense accounts, including yachts, club dues, and so forth, are deductible from taxable income, while the expenses of an ordinary person driving to and from work, or the payment of rent, or expenditures for the recreation or education of one's children are not deductible. These privileges for deductions and allowances go almost entirely to the strong, the powerful, and the well-to-do, and favor high income groups and unearned income as opposed to low income groups and earned income.

The main purpose of tax reform is to try to modify or to do away with some of these inequities and privileges in the tax laws.

What the investment credit does is to say that for social purposes we should give a special tax privilege for funds used to buy most kinds of depreciable property. At least as good a case can be made that society would be as wise to allow deductions for money spent for the education of children, for a future pension, or for preventive medicine rather than for capital investment.

Every legislator is pressed almost daily by some constituent or interest group to vote for a tax deduction for their particular interest. Once we start on this road it is almost impossible to stop. For this reason alone it is very unwise to give a special deduction for funds which are spent in this particular way; namely, for capital investment. It would be equally unwise to give deductions for most of these other proposals.

If the 7-percent tax credit is allowed on machinery and equipment, it will be only a short time before it will be granted on plant and buildings, and this will amount to another revenue loss of not far from $1.5 billion. Indeed, proposals to this effect have already been made. Residential construction would not be left behind for long and this would take another $1.5 billion away from our revenue. It would also be inevitable that the principle of H.R. 10 would find its way into enactment, and moneys devoted to purchasing voluntary retirement plans would be exempted from taxation. So would expenditures to educate children in college.

The final result would be that only income spent for current consumption would be taxed. This would be a kind of sales tax which would be highly regressive in nature and would weigh proportionately far more heavily upon those with lower or middle incomes than upon those with large resources. State and local taxation is already highly regressive. This is only made bearable by the fact that Federal taxation is progressive and hence introduces a kind of rough proportionality over the range of most incomes. To make Federal taxation also regressive or less progressive would in our opinion be grossly unjust. And yet that is precisely the end result toward which the opening of these loopholes would tend. We cannot acquiesce in these tendencies however well intentioned they may be.

THE DELETION OF WITHHOLDING ON DIVIDENDS AND INTEREST

I

GENERAL STATEMENT

By striking out of H.R. 10650 the plan for withholding tax from dividend and interest payments, this committee is, in effect, indicating that it condones the intolerable gap in the payment of taxes on dividends and interest, in many cases the result of outright and willful evasion. The Secretary of the Treasury estimates that in 1963 the gap between the dividends and interest that should be included on tax returns, and those that actually are, will exceed $3.7 billion. This will mean a revenue loss to the Government of almost $1.1 billion—$440 million of taxes owed on dividends, and $650 million of taxes owed on interest. Withholding would collect $880 million of this $1.1 billion. Withholding combined with the other collection and enforcement procedures available to the Internal Revenue Service would close nearly the entire gap. Without withholding, less than one-fourth of the gap can be closed. But even this cannot be accomplished until the Internal Revenue Service's new automatic data-processing system becomes fully operational in 1967.

Why must we forego hundreds of millions of dollars of additional revenue each year which is rightfully owed the Government? Why must the millions of honest taxpayers who conscientously report their dividends and interest continue to pay more than their fair share of taxes in order to make up the $880 million of lost revenue that could be collected through withholding.

Why must we continue to tolerate a tax system under which millions of wage earners pay their full share of taxes while many of those more fortunate individuals who have capital to invest are allowed to escape more than a billion dollars of taxes every year on their dividends and interest? Just look at the facts. As a result of the wage withholding plan, which has been in operation since 1942, only 3 percent of the taxes due on wages go unpaid. On the other hand, in 1960, more than 11 percent of the dividends that should have been reported on tax returns of individuals were not so reported. The situation is even more intolerable for interest where more than one-third (34 percent) is omitted from tax returns.[6] Who are the people who do not pay their taxes on interest and dividends? Of the nonreported dividends, according to a sample of from 6,000 to 8,000 returns, about 70 percent were received by individuals with *more* than $10,000 of income. Of

[6] 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.

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.

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.

the nonreported interest, only about 30 percent was received by people with less than $5,000 of income, while approximately 30 percent was received by those with incomes of more than $10,000. If a withholding system is appropriate for the lower income wage earners, to make sure they pay their taxes, then what possible excuse can there be for not applying it to help collect the taxes on dividends and interest from the many higher income individuals who escape those taxes today?

The answer that is given is that withholding would be too burdensome and that it would hurt too many people. In addition, we are told that the committee's substitute, an expanded information-reporting system, will give the Internal Revenue Service all it needs to collect most of the unpaid taxes. Neither of these propositions can be supported.

II

INFORMATION RETURNS NOT A SUBSTITUTE FOR WITHHOLDING

The Commissioner of Internal Revenue, the man who actually does the job of collecting our taxes, has carefully studied both the withholding plan and the expanded information-reporting program and has concluded that information reporting, even when coupled with the Service's new automatic data-processing system, cannot be an alternative to withholding. This is because an ADP information return system in itself will not collect one penny in taxes. All it can do is identify possible discrepancies which then must be followed up through the ordinary collection and enforcement procedures available to the Internal Revenue Service.

The figures [6] tell the story themselves:

Of the $850-million gap in the reporting of taxes on dividends and interest, withholding *alone* would recover $650 million at a cost of approximately $19 million. The remaining $200 million could be recovered in large part by the ADP system, combined with a reasonable enforcement effort for an estimated additional cost of $29 million. In other words, the entire gap could be closed through a combination of withholding and enforcement for a cost of only $48 million.

To close the entire gap without withholding would be physically impossible and economically unfeasible. It would mean contacting 12 million people for the purpose of checking discrepancies in their dividend-and-interest reporting turned up by ADP. This is three times as many people as the Service contacts today in its total enforcement program. It would cost $400 million to collect the $850 million by this method, more than eight times the cost if withholding were used.

Even if we were to collect all of the $650 million (the dollar equivalent to the results under withholding), it would cost $200 million to collect this amount, or more than 10 times what it would cost under withholding. In addition, the Internal Revenue Service's present enforcement staff, which through its activities collects about $3.5 billion annually, would almost have to be doubled to collect the additional $650 million. The resulting imbalance in enforcement effort is one that cannot be reconciled with any sound concept of tax administration.

[6] These figures are based on the 1959 revenue gap estimate of $850 million. It is estimated that this gap will rise to $1.1 billion in 1963.

To look at the matter realistically, and within the concept of a sensible and effective use of equipment and enforcement manpower, based on 1959 data, the information-reporting system adopted by the committee can be expected to recover only $200 million.

These figures, which were compiled by the Commissioner and his staff after careful study of the matter, conclusively prove that the information-reporting system adopted by this committee is not a substitute for withholding.

Even apart from its complete ineffectiveness as a tool for closing the more than $1 billion gap in the reporting of taxes on dividends and interest, the information-reporting plan adopted by the committee is at best a clumsy and burdensome substitute for the relatively simple withholding plan adopted by the House. Under withholding, a payer of dividends or interest would merely be required to deduct a flat 20 percent from its payments to persons who have not filed exemption certificates and then make one lump-sum payment to the Government each quarter. The payers will not have to make out individual withholding receipts for each recipient nor will they be required to submit any detailed records to the Government.

The burdens under the information-reporting plan will be substantial when compared to this. At the end of the year, each payer will be required to add up all the dividend or interest payments it has made to a person during the year and, if they equal or exceed $10 in the aggregate, make out an information return showing the name and address of that person and how much was paid to him during the year. Then this information must be filed with the Government and a copy given to the recipient. This means that the payer must make a reasonable effort to obtain the current address and account number for each of its depositors or stockholders. Translated into numbers, payers of dividends and interest will be required to complete and file with the Government 100 million pieces of paper each year and then distribute an additional 100 million copies to their depositors or stockholders.

The savings and loan industry has admitted that this information reporting plan will involve heavier administrative costs for them than withholding.

III

WITHHOLDING IS AN EFFICIENT AND EFFECTIVE METHOD TO CLOSE THE GAP

The withholding plan included in H.R. 10650 as passed by the House of Representatives has been grossly misrepresented and distorted by its opponents. They have fostered widespread misunderstanding of the plan and aroused baseless fears.

Basically, the plan is very simple. The institution which pays interest, dividends, or patronage dividends would be required to deduct a flat 20 percent from these payments and remit the total amount to the Government once a quarter. The plan includes several relief provisions which would insure that individuals and other taxpayers who owe little or no tax on their dividend and interest income will not be unduly harmed by withholding. These three basic objections have been made to the plan: it would hurt many people with low incomes who depend on their dividend and interest income for living expenses; it would result in a maze of paperwork and confusion for the taxpayer; and it would impose heavy burdens on the paying institutions. We have already pointed out that withholding would be far less burdensome to the payers than the new information reporting plan. The other two objections are equally groundless.

1. Withholding would not hurt low-income individuals

There have been repeated accusations that withholding will unfairly deprive low-income people of funds which they need to meet their living expenses. This is just not true. Those with such low incomes that they do not owe any taxes could completely avoid withholding in most every case merely by filing simple exemption certificates with the paying institutions. Children under age 18 would be exempt from withholding regardless of their tax status. There can be no hardship for these people since withholding will not even apply.

It is true that there would be some people who, although they owe some tax, would be subject to overwithholding. These people, however, can obtain quarterly refunds of the overwithheld tax merely by filing a simple refund claim. Under the ordinary procedures, the refund would be paid within 3 to 4 weeks after the claim is filed. The Internal Revenue Service has developed a system whereby an individual who claims a refund for the first quarter will automatically be mailed claims for the next two quarters to insure that he does not forget to claim his refund. What is the hardship to these people? It is merely the loss of the interest that could be earned on the overwithholding for the first quarter, since the quarterly refund for the first quarter would offset the overwithholding in the next quarter and so on indefinitely.

The efficiency of these provisions in preventing hardship can best be shown by an illustration. Under the present law, which gives people over 65 a double exemption and also a tax credit on retirement income, an elderly couple (where it is claimed hardship will be most common) can have as much as $5,377 in income each year from social security and interest and yet be liable for no tax and, consequently, no withholding. Such a couple would be receiving the maximum social security benefit of $2,178 and interest income of $3,199. This amount of interest represents a savings account of about $80,000 earning interest at 4 percent.[7]

An elderly couple receiving the maximum social security benefit and $4,199, rather than $3,199, of interest would fall into the overwithholding category. The withholding each quarter would be $210—$160 more than their tax liability. Under the quarterly refund procedure, this couple would never be out of pocket more than the $160 of overwithholding for the first quarter. Even if the $160 must be withdrawn from the couple's savings account, it would mean a loss of

[7] The following is a schedule showing the tax computation for the couple in the example:

Total income	$5,377
Less social security benefits	2,178
Income subject to tax	3,199
Tax before retirement income credit (computed from optional table on the basis of 4 exemptions and the standard deduction)	92
Retirement income credit	92
Tax liability	

The example assumes that $\frac{2}{3}$ of the social security benefits are received by the husband and $\frac{1}{3}$ by the wife, which is typical where the husband has been the wage earner.

only $6.40 for an entire year, representing the interest on $160 if left in their savings account at 4 percent. This $6.40 loss must be analyzed in the context of the $105,000 savings account which this couple must have to earn $4,199 of interest for the year.[8] Is there hardship in this case?

When compared to wage withholding, the overwithholding involved in dividend and interest withholding is minimal. About 37 million refunds representing overwithholding on wages are made each year with little or no complaint on the part of the taxpayers. This was about 60 percent of the wage returns upon which taxes were paid. The average return for the 37 million wage refunds amounts to about $142. Even taking into account the fact that quarterly refunds will be permitted, only about one-fifth as many refunds will need to be made under dividend and interest withholding as under wage withholding. To look at it another way, 14.3 percent of the taxes collected by wage withholding must be refunded; the comparable figure for dividend and interest withholding is only 5.5 percent and most of this will be returned *quarterly*.

It is clear that hardship to low-income individuals cannot be used as an excuse for abandoning withholding. There just is no such hardship.

2. Withholding will be a simple and efficient means for an individual to pay his taxes on dividends and interest

It has been claimed that withholding will result in a maze of confusion for the American taxpayers. For the great majority of taxpayers, the only burden caused by withholding will be two additional computations on the tax return—those involved in a simple schedule. In addition to entering the amount of his dividends and interest on the return as at present, the taxpayer will, as a result of withholding, be required to divide this amount by four and then add these two amounts together to determine the amount of his dividends and interest to be reported as income and the amount of credit he is permitted for the withheld tax. This is the extent of the "maze of confusion" for the taxpayer.

For many taxpayers, withholding will actually reduce their paperwork, by eliminating the necessity for filing quarterly estimated tax returns.

Those who raise this objection completely ignore the fact that most Americans already operate under a much more complicated withholding system on their wages, with no maze of confusion. It is to ignore reality to say that they will not be able to adapt to the much simpler system for withholding on dividends and interest.

IV

WHO WILL BE HURT BY WITHHOLDING?

Withholding will definitely hurt a sizable group of individuals—those who fail to pay the taxes due on their dividend and interest income. It is only fair to the millions of taxpayers who already do

[8] It has been argued that the loss from overwithholding will really be much greater because of the compounding factor. Assuming a savings account where interest is credited quarterly, the loss of interest on the $160 over a 10-year period will only amount to $78.22 taking into account the compounding. This is an average loss of $7.82 each year, which is still minimal when compared to the $105,000 savings account involved.

this that these individuals be required to do the same. One of those who signed this report received 75,000 letters on withholding and a sampling of these letters showed that between one-third and one-half of them were from people who thought withholding represented a new tax on dividends and interest. Another large group thought withholding was a tax on capital.

V

SUMMARY

Withholding on dividends and interest is urgently needed—without it, this country will continue to forfeit billions of dollars in revenue that is rightfully owed by those individuals who are not assuming their fair share of the tax burden. Information returns and ADP are not a substitute for withholding.

Expense Accounts

One of the best known and most resented special privileges in the tax law today is the deductible expense account. President Kennedy described this tax giveaway as "a matter of national concern." The House of Representatives agreed. After long and careful consideration it passed a provision which, although falling short of the President's recommendations, would go a long way toward a fairer set of rules. It would permit deductions for entertainment more closely related to the conduct of business but would cut out deductions for many of the highly personal expenditures permitted under present law when the taxpayer can make a showing of some connection between the entertainment and the taxpayer's trade or business.

The allowance of deductions for such essentially personal entertainment has brought the integrity of the entire revenue system into disrepute. The expense account deduction has been a breeding ground for fraud and misrepresentation. It has encouraged disrespect for honest self-compliance with the tax laws among those not in a position to claim such deductions, but who have watched others satisfy their personal amusement at the taxpayers' expense.

What has the Finance Committee done with the House bill? It has simply pulled the teeth from the proposal, leaving it merely with a dangling tongue—a tongue which is certain to confuse taxpayer and Government official alike as to what it is trying to say. Certainly the vague and almost meaningless standard adopted by the committee will do very little, if anything, to change the style of operation of those who have been living high on their expense accounts at the cost of their fellow citizens.

Let us be more specific.

I

THE PROBLEM

The basic problem is whether this country can continue to afford to permit a small group of taxpayers to take tax deductions for highly personal items such as nightclub hopping, fancy yachts and swanky country clubs while the great majority of their fellow taxpayers cannot take such deductions. From a practical point of view the concern of the Nation is not only the basic unfairness of this situation (in itself a vital consideration) but it is also the effect that this legally created unfairness has upon those who are discriminated against. It makes them resentful of the law which permits such a situation to exist and encourages them toward laxness in discharging their full tax obligations. It is quite natural to feel: "Why should I help keep that fellow on the gravy train—paying for his fancy yacht and swanky country club?" An expansion of this type of thinking could eventually destroy our tax system, the keystone of which is its voluntary character. We rely on each taxpayer to be his own tax assessor. The essential honesty of our citizens and, most important in this contex, their respect for our tax laws, has enabled this system of voluntary self-assessment to function most effectively. However, like all good things, the system must be nurtured and protected.

Expense account abuses have become a real threat to the continued effectiveness of our self-assessing system. Much taxpayer distaste has already been voiced against this unwarranted privilege. The danger signals are loud and clear. In his testimony before the House Ways and Means Committee and the Senate Finance Committee, the Secretary of the Treasury documented the situation in great detail with numerous case studies and many samples of editorial comment from all over the country. Let's examine a few of these.

A corporation engaged in manufacturing was allowed to deduct $991,665 in 1959 for yachts, club dues, shipboard conventions, hunting and fishing trips and parties.

A taxpayer engaged in the insurance business was allowed to deduct $97,500 for meals, lodging, transportation, entertainment, tickets, books, gifts, et cetera. The amount covered $6,000 for an apartment and over $30,000 for food, beverage, and other entertainment.

A manufacturer was allowed to deduct over $34,000 spent on liquor, football tickets, parties, and a speedboat, The expenses for liquor alone totaled $13,750.

A family-held ship repair corporation was allowed to deduct $23,758 for a Christmas dinner and party.

An enterprising banker effectively combined sentiment with business when he deducted, as present law permitted, a substantial part of the cost of his debutante daughter's coming-out party on the ground that some of the guests had business connections with him.

In another case, the taxpayer was allowed $115,000 for entertainment and gifts. His expenses included $7,500 spent at a resort hotel; $5,400 for food, liquor, and cigars for his office and farm; and $8,700 in cash to officers of his closely held corporation for entertainment.

A beverage manufacturer claimed and was allowed $10,903 for entertaining customers at the Kentucky Derby.

Huge sums are allowed to business taxpayers in connection with maintenance and operation of yachts and other fancy boats. One manufacturer was allowed to deduct $253,000 for the expense of his yacht. Another was permitted to deduct $112,000 for such expenses (as well as an additional amount of $362,000 for a ranch-hunting lodge, nightclub, and other similar expenses). A company in the business of selling fuel was allowed $93,000 as deductions for a yacht, a fuel products company was allowed $23,000 and an auto dealer was allowed yacht expenses of $22,000.

A cake and cookie bakery was allowed $66,000 for a yacht on which to entertain supermarket and chainstore buyers and branch managers.

Despite its rather sad undercurrents, both from the viewpoint of the tax system as well as otherwise, one of the most interesting cases is that in which a mortuary business was allowed $26,495 for yacht expenses to entertain visiting morticians, clergymen, and for meetings of employees.

These cases could be multiplied by the thousands. Similar large expenditures are constantly being made on hunting and fishing lodges, on elaborate beach resort homes, on exotic island retreats, on extended hunting trips, including plush safaris to far off Africa and India. Indeed, just about every kind of human activity in the nature of fun and frolic is being well subsidized on behalf of a privileged few by the average taxpayer who does not happen to be engaged in a trade or business so as to enable him to join in this Government-supported high life. Is it any wonder, then, that such strong taxpayer resentment has developed against the expense account privilege. Clarence Randall, former chairman of the board of one of America's largest steel companies has vividly expressed this taxpayer resentment in the following words:

> 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 duckblind 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, copilots 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. * * *
>
> 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.

The important point to be derived from the foregoing is that all of the expenditures described were deductible under the broad standard of present law which permits the deduction of "all the ordinary and necessary business expenses" of the taxpayer. The fact that there is a business relationship, actual or even only hoped for, between the parties does not prevent them from enjoying the fancy resort living, the cruise on the expensive yacht, or the fancy nightclub.

Suppose company A sells its product to company B. If a sales executive of company A invites his close friend, an executive of company B, to join him for a cruise on his yacht, who can say that the executive of A did not intend to promote the business relationship between the two companies? The fact is that in the usual case the businessman's friends are his business customers or prospects. Under the test of present law, so long as this business connection exists between entertainer and entertained, the parties can enjoy tax deductible vacations in Bermuda, cruises on yachts and evenings in luxury nightclubs on a tax deductible basis. This can be done on a reciprocal arrangement of "you entertain me and I'll entertain you," with the Treasury paying half the bill for each. Business does not have to be discussed nor need the entertainment follow or precede business discussion. The taxpayer need not even be present at the entertainment. Because of absence of restrictions, taxpayers are encouraged to ask "Why should not I deduct my personal pleasures and entertainment, if everyone else can?" Because of this the expense account problem has grown to its present unmanageable proportions.

II

HOUSE SOLUTION TO THE PROBLEM

The test adopted by the House of Representatives is that the expense of an entertainment activity will not be deductible unless "directly related to the active conduct of the taxpayer's trade or business." Where an expense connected with a facility such as a yacht or a hunting lodge is involved, the taxpayer must also show that the facility "was used primarily for the furtherance of the taxpayer's trade or business." On its face, this standard seems almost as broad as present law and would appear to present many of the same problems.

However, in its report the House Ways and Means Committee has explained its test in a way which provides a number of tangible, practical, and meaningful guidelines: The report states that under its test the taxpayer—

> * * * will have to show more than a general expectation of deriving some income at some indefinite future time from the making of the entertainment-type expenditure; however, he will not be required to show that income actually resulted from each and every expenditure for which a deduction is claimed.
>
> If the expenditure is for entertainment which occurs under circumstances where there is little or no possibility of conducting business affairs or carrying on negotiations or discussions relating thereto, the expenditure will generally be considered not to have been directly related to the active conduct of business. Thus, the absence of the taxpayer or his representative from the entertainment activity ordinarily indicates that the entertainment was not directly related to the conduct of the taxpayer's trade or business. Similarly, if the group of persons entertained is large or the distractions substantial, the cost of the entertainment will not be deductible, in the absence of a clear showing of a direct relationship to the active conduct of the trade or business.

This clear statement of legislative intent coupled with the statutory language provides a workable and reasonable solution to the difficult expense account problem and should go a long way toward reducing the abuses outlined above. However, critics of the House proposal attacked this crucial committee report statement on the ground that it had no support in the statute.

In view of the broad language of the statute, requiring explanatory implementation to make it useful, this contention is baseless. The true reason for the complaint is the fact that the statute as interpreted by the Ways and Means Committee report has some real teeth in it.

Even so, we are not asking that the business community adopt Spartan standards. The House bill, which we hope will be restored, recognized the general custom of business entertaining at meals in restaurants. It specifically permits the deduction of entertainment presently allowable through furnishing food and drink in restaurants and hotels in an atmosphere conducive to business discussion. No business need be discussed. It thus leaves undisturbed the most significant portion of goodwill entertainment conducted in this country. It strikes only at the high, wide, and fancy living and indulgence in personal pleasures which all taxpayers ought to pay for themselves without Government subsidy.

III

FINANCE COMMITTEE SOLUTION—FORMULA FOR CONFUSION

The only change in the pertinent House statutory language made by the Finance Committee is the addition of the words "or associated with." Thus, a taxpayer can deduct an entertainment expenditure which is only "associated" with the active conduct of his trade or business, as well as one which is directly related thereto. Since this statutory language is quite similar to that of the House bill one would reasonably expect again to find a helpful explanation as to what the committee intended to accomplish by its additional phrase "or associated with."

Unfortunately, such is not the case. Unlike the clear, concise, and workable guidelines set forth in the House report the Finance Committee report is a mass of vague, disconnected statements and examples which are destined to spawn controversies more numerous and intense than those which occur with such disturbing frequency under present law.

Although the Senate report attempts to paint a picture of virtue and righteousness, even a casual glance beneath the surface reveals that the virtuous exterior is more illusion than reality. For example, the report states:

> * * * Nothing in your committee's bill is to be construed as allowing a deduction for any expense which is against public policy or which violates the public conscience. Deducting an expense incurred for such purpose under the guise of generating "business goodwill" will not be condoned and under your committee's amendment is not deductible. Thus, the cost of liquor purchased for the entertainment of customers and the promotion of goodwill (which under existing law has been held deductible) will be disallowed if the serving of liquor violates the public morals of the community as expressed in local law. Another example of expenses for immoral purposes which have been claimed on tax returns under existing law involves expenditures to provide "call girls" for the purpose of entertaining clients. Under your

committee's amendment no deduction whatsoever is to be allowed for expenditures of this nature. In no legitimate sense are they "directly related to or associated with the active conduct" of a trade or business.

The foregoing suggests that the committee's action will serve as a moral broom to disallow expenditures where liquor is illegal under local law, and where "call girls" are utilized as "business" entertainment. However, expenditures such as these, which violate clearly defined lines of public policy, are not deductible under present law. See *Smith*, 33 T.C. 861 (1960); *R. E. L. Finley*, 27 T.C. 406 (1956); *U.S.* v. *Winters*, 261 F. 2d 675 (1958). What then will be accomplished under the committee's language? Is it not clear that this is simply a smokescreen thrown up to suggest that abuses are being remedied whereas in actuality little, if anything, is being accomplished beyond present law?

The Finance Committee report stresses the desirability and wholesomeness of "goodwill" entertainment. It states:

> Goodwill has long been recognized as a legitimate objective of business entertaining and where the purpose of the expense and its clear relation to a business is firmly established, *the expense ordinarily will continue to be deductible*. [Emphasis added.]

The report further states:

> To eliminate the harshness resulting from the House report, amendment of the language of the House bill is necessary. * * * This new language will permit deduction of expenses for entertainment, amusement, or recreation incurred for the creation or maintenance of business goodwill without regard to whether a particular exception applies. However, this new language will apply only if the taxpayer demonstrates a clear business purpose and shows a reasonable expectation of deriving some income or other benefit to his business as a result of the expenditure. If he meets this test, the expenditure will be considered to be associated with the active conduct of his trade or business; otherwise, the expense will be disallowed under your committee's amendment.

A close analysis of these statements makes it eminently clear that expenditures for goodwill have been given preferred status. In these references to "goodwill," the committee has presented our sophisticated expense account society with a blueprint for continued high living at Government expense. These statements constitute a formula which will leave the Internal Revenue Service with an impossible enforcement task, for, in effect, almost all entertainment expenditures, both for the creation and maintenance of business goodwill are declared to be henceforth deductible. In stating that the taxpayer must demonstrate a clear business purpose and show a reasonable expectation of deriving some income or other benefit to his business from the making of the entertainment expenditure, the committee report has added nothing to the requirements of present law. The taxpayer must meet precisely the same test today, but, as hundreds of cases illustrate, such vague and generalized requirements at present are so easy to meet as to be practically meaningless.

Furthermore, although the committee report makes numerous references to goodwill, it gives no indication as to what is encompassed by this term. Nowhere is goodwill defined. How does a businessman go about creating goodwill—whatever goodwill is? It seems clear that the sky is the limit. If a businessman—in his judgment—thinks a big yacht may be helpful in developing some customers, doesn't this committee report language put the official congressional stamp of approval on his deduction of these substantial costs of maintaining and operating such a "business" asset? Is not a revenue agent foreclosed from effectively examining into the matter?

In the light of all the foregoing statements respecting good will, very little is salvaged from the following comment—particularly in view of the illustration given as to what is meant by "vague goodwill."

> Where good will generated by the expense is vague or where the possibility of the expenditure resulting in the production of income is remote, no deduction will be permitted. For instance, under present law a taxpayer may deduct expenses of entertaining buyers and others associated with his trade or business even though at the time he does the entertaining he already has more business than he can handle. Under you committee's amendment, however, no deduction will be allowed because, with a large backlog of unfilled orders, such entertainment ordinarily cannot be regarded as being associatedwith efforts to produce income.

This narrow "exception" to the basic theme of the Finance Committee report that all good-will entertainment is deductible is scant evidence of tightening up present law. Rare indeed is the case where the taxpayer has such a backlog of unfilled orders that his entertainment activities cannot be regarded as being associated with efforts to produce income. It is interesting to note that even in such an extreme case the report hedges the consequences by providing that "ordinarily" the deduction will not be allowed. Moreover, there is a good possibility that entertainment expenditures in such a unique case are not deductible under present law because they are in the nature of capital expenditures. Cf. *James Schulz* (16 T.C. 401). Here again the committee has done nothing more than set up a strawman—to give the illusion that a cutback on existing law is being effected. In reality nothing has been accomplished—except that perhaps another arena for conflict has been created.

The "harshness" of which the report speaks is that the House provision, as explained by the Ways and Means Committee's report, has some effect and will disallow some entertainment expenditures which are deductible under present law. Presumably that is the purpose of this legislation. However, one must struggle hard to tell which of the above-described cases would be denied deduction under the Finance Committee report. How much, if anything, would be disallowed to the corporation which spent and deducted almost $1 million in 1 year for yachts, club dues, shipboard conventions, hunting and fishing trips, and parties? Does not a corporation make such expenditures to develop good will? We have already seen that good-will expenditures are clearly deductible under the Finance Committee report. How about the banker who deducted a substantial part of the cost of his daughter's coming-out party as a business expense? Wasn't he also developing customer good will? Certainly the Government is not, under the Finance Committee report, free to disallow expenses regardless of the form of entertainment the taxpayer may adopt to develop good will. Similarly, in all the other cases set forth above, the taxpayer would appear to be able to continue to deduct all entertainment expenditures.

Under the Finance Committee report, do yachting expenses continue to de deductible? If not, then the report should clearly so state. Does the cost of maintaining hunting lodges for entertainment continue to be deductible? If not, then the committee report should so state. Is the cost of wining and dining at nightclubs deductible? If not, the committee report should clarify the situation. Do tickets at $30 apiece for musical comedies continue to be deductible? If not, the committee report should so indicate or provide some standard or guideline by which the answers to these questions can be determined by the taxpayers and revenue agents who will be left floundering in their attempts to know what the rules are.

One further "red herring" in the Finance Committee report should be mentioned. The report states that no deduction will be allowed for entertainment expenses "which under the circumstances in which they are incurred are lavish or extravagant." Here again no standards or guidelines are furnished. What is lavish or extravagant under the circumstances? If the circumstances involve a taxpayer accustomed to entertaining in an elaborate and expensive style, can they be held to be "lavish" under the circumstances? When does a yacht become an extravagant expenditure? When it is 60 feet in length? 100 feet in length? Would these criteria vary with the income (or expected income) of the taxpayer? Would a resident of Miami Beach, Fla., be entitled to a bigger and more expensive yacht than a resident of Providence, R.I.? Would a beach home with eight rooms be a lavish facility? What about one with 30 rooms? Would a corporate president be entitled to drink champagne whereas a vice president could have only a whisky highball and a proprietor of a country grocery store only ordinary corn liquor?

Is it not abundantly clear that the so-called "test" produced by the Finance Committee, superimposed upon the unsatisfactory test of present law, will simply compound existing difficulties? The litigation and controversy which would follow adoption of such meaningless language would even make the present situation seem a happy one. The result would be a real mess. And to what avail? In this posture of things, it seems quite proper to ask—what is wrong with the proposal adopted by the House of Representatives? It is obviously far superior to the Finance Committee's product. We urge the Senate to approve the House provision or the President's original proposal and again, as it did in 1960, produce a really significant legislative measure to deal with expense account abuses.

THE DEDUCTION FOR CERTAIN LOBBYING EXPENSES OF TAXPAYERS WITH BUSINESS INCOME

Section 3 would permit the deduction of certain lobbying expenses by taxpayers with business income. This would depart from a salutary principle which has been part of the income tax law since World

War I. It would provide unwarranted tax reduction where it is least needed for reasons which are specious. It would introduce novel distinctions into the tax law, producing new requirements difficult for the Internal Revenue Service to administer. The specific language in which the deduction is cast contains ambiguities which will create continuing uncertainty as to its exact meaning, and, most important, the relationship of this provision to the whole process by which our citizens seek to influence the enactment of legislation at all levels of government was not adequately considered. Section 3 should be deleted from the bill.

Under existing law the costs of efforts to influence legislation are not deductible, a rule applicable to *all* taxpayers. Whatever the motive for a citizen's efforts to influence legislation, he now bears the whole cost of that effort himself. No part of the expense can be passed on to the Federal Government through an income tax deduction. In the constant competition for legislative favor and results at National, State, and local levels, the Federal Treasury stands neutral—and properly so.

Section 3 would change all that. It would amend section 162 of the Internal Revenue Code of 1954, the section creating the general authority for deduction of the ordinary and necessary expenses of business operation. Section 3 would add a new subsection specifically authorizing deduction of lobbying expenses in certain categories by taxpayers with business income. Only those taxpayers with business income would receive any benefit. All others would still be subject to the existing rule of no tax benefits for lobbying, a result which follows necessarily from incorporation of the amendment in section 162 and one which is specifically spelled out by the House committee report.

Some specific typical examples will bring this into sharper focus. Suppose a measure is being considered, as many have been, involving a proposed change in the standards or testing procedures for food, drugs, or cosmetics. The costs of presenting the views of drug manufacturers and distributors would be deductible. The cost of presentations on behalf of consumers or of disinterested professional or technical advisers would not be. Or suppose that a State legislature is debating a measure designed to decrease stream pollution. Manufacturers who would be adversely affected by its enactment could deduct the cost of opposition. Members of the public interested in pure water for drinking or for recreational uses would have to finance their support of the measure entirely from their own pockets. Or, at the local level, a business owner of a piece of real estate could seek advantageous amendment of the local zoning ordinance, deducting the cost of his presentation before the local city council. The owners of nearby residences would not receive this help from the Federal Treasury in preparing the exhibits and briefs necessary for effective opposition.

These are discriminations impossible to justify. Can anyone seriously contend that consideration of legislative proposals affecting business taxpayers is seriously handicapped by absence or weakness of expression of business viewpoints? Is there any evidence that business taxpayers, individually or collectively, are now deterred from expressing themselves on these subjects by the present rule of tax neutrality which permits no deduction for lobbying expenses? To ask these questions is to answer them. Of all viewpoints on legislative proposals, those of business are consistently the most ably represented before the Congress and before State and local legislative bodies. Why then should the cost of lobbying activities of taxpayers with business income be singled out for this preferential tax reduction? No adequate reason has been given.

Any discrimination at all among citizens in the exercise of their constitutional right to petition their representatives is patently undesirable. Discrimination by preferential tax deduction is magnified as the amounts spent for these purposes increase. Modern efforts to influence legislation cover a wide range of techniques, some of which are very costly. One can send a letter to his Senator for 4 cents. However, to stimulate tens of thousands to do so requires the expenditure of large amounts running sometimes into the hundreds of thousands, even millions, of dollars. But all this is well known. It has been thoroughly documented many times.

The application of section 3 would not be confined to nominal amounts. It would permit the deduction of some very large sums. In addition to provision for deduction of the costs involved in direct contacts with legislators (personal calls and visits, appearances before committees or statements filed with them), the cost of efforts to influence legislation indirectly are also made deductible in some instances. The costs of communications to organization members and to shareholders and employees have all been blanketed in.

When section 3 is applied to today's scene, we find that it will authorize giant corporations to deduct the cost of communicating the views of management officials to hundreds of thousands, even millions, of shareholders and employees, for the purpose of influencing them with respect to current controversial legislative proposals. To use a painfully familiar example, section 3 would authorize deduction of the cost of campaigns designed to produce a flood of letters opposing withholding on dividend income.

Under existing law these sums are not properly deductible—and never have been. To permit deduction now would shift a very large proportion of these heavy costs to the Federal Treasury, a disguised subsidy for which there would be no justification.

The effects of such subsidized efforts to influence legislation indirectly would not be confined to the recipient members, shareholders, and employees. The views expressed and their source would frequently come to the attention of families and friends of the recipients, thereby broadening the scope of the influence subsidized by the Federal Treasury. Of course, the benefits of section 3 as they would apply to these broadcast efforts to influence legislation can only benefit very large organizations. Small business taxpayers, as well as nonbusiness taxpayers, would have little or no use for it and could well suffer from its use where their interests on legislative matters are opposed to those who could take advantage of it.

True, not all lobbying costs of business taxpayers would be made deductible by section 3. The bill purports to create limitations which will restrict the kind of expenses for which a deduction can be claimed. Thus, to qualify for the deduction, the legislative proposal must be of "direct interest" to the taxpayer. In addition, specific provisions deny deductions for political campaign expenses or for efforts "to influence the general public, or segments thereof." However, a close inspection raises genuine doubt as to the precise meaning and application of these restrictions. They may, in fact, prove largely illusory.

Thus, one might ask, What subjects are not of "direct interest" to a large corporation? Any measure involving a tax or a change in the regulation of business or the marketing of securities or foreign trade or the terms of employment or labor relations or the monetary system will have some impact on every substantial business enterprise. Is it intended that the cost of testimony or statements or communications to shareholders or employees on this entire range of subjects is to be deductible? Similarly, can the prohibition against deductions for political campaign purposes be really effective? Granted that the cost of a folder urging shareholders to vote for Jim Darkwater will not be deductible, what of the cost of a folder urging a position on the principal issue dividing Darkwater from his opponent Bob Cleanriver? Can issues and the candidates be separated so easily? It is doubtful. Section 3 thus could make slightly veiled political contributions deductible. The benefit would not be universal though. To return for a moment to the anti-water-pollution measure used as an example before, suppose Darkwater is against it and Cleanriver is for it. The former's supporters could deduct the cost of their literature discussing the antipollution measure (and thus their support of Darkwater); supporters of Cleanriver could not.

Obviously, congressional memories are very short. For at least a century Senators and Representatives have regularly inveighed, individually and collectively, against lobbyists and their activities. The need for substantial disclosure by lobbyists, particularly in financial respects, has long been recognized. When a person or organization becomes a lobbyist, he is required to register as such and thereafter to report quarterly his expenditures for these purposes. In spite of these safeguards, every few years some lobbyists become so bold and their overreaching so bad that a special inquiry is required. A prime example was the creation in the 84th Congress of the Senate Special Committee To Investigate Political Activities, Lobbying, and Campaign Contributions. Its report states graphically the kinds of abuses which occur and the large sums of money available to be spent on efforts to influence legislation. Sugar quota bills attract lobbyists like flies and, like flies, their activities are not widely admired. The Senate Foreign Relations Committee is currently beginning an investigation of another group of lobbyists, an inquiry which has grown in large part out of concern for their lucrative financial arrangements. Nor are problems with lobbyists confined to Washington. Their influence on State legislators and their sometimes questionable methods in State capitols is notorious.

When projected against all this experience, section 3's proposed financial bonanza for one group of lobbyists and their employers seems ironic in the extreme, if not downright cynical.

There is no challenge here to lobbying per se. It is unquestionably legitimate. A constitutionally protected right of our citizens, it often supplies useful information and reactions on pending legislation. However, it would be foolish to exalt it unduly for these reasons. At best, lobbying is a mixed blessing for it is almost always exclusively concerned with self-interest rather than the broad public interest. Fortunately, section 3 presents only a narrow problem, viz., whether or not the lobbying done by one segment of our society—taxpayers with business income—should be entitled to support from the Federal Treasury.

A number of arguments are made in favor of this measure. Some of them have a surface plausibility, but on close analysis none of them holds water. The issue is actually a simple one. We begin with a longstanding rule that all taxpayers, business and nonbusiness, who seek to influence the work of legislative bodies, National, State, or local, pay their own expenses in full without assistance from the Federal tax system. This neutral posture of the tax law is a healthy one and should be defended and strengthened. Legislation affects all our citizens. It is entirely suitable that all who seek to influence that legislation, directly or indirectly, should be treated alike. The expenses of all should be on the same footing as far as the Treasury of the United States is concerned. The only issue here is whether or not to depart from this principle of neutrality and equality. Plainly, the case for such a change has not been and cannot be proved.

Foreign Operations

I

General Statement

Except for withholding on dividend and interest income, which was defeated outright, no major aspect of the President's recommendations for tax reform contained in his message to the Congress on April 20, 1961, suffered so badly at the hands of the Finance Committee as did those recommendations relating to the taxation of income and profits earned abroad by U.S. persons.

President Kennedy recommended that American corporations, as well as individual U.S. taxpayers who are "shareholders of closely held" foreign corporations, be taxed each year "on their current share of the undistributed profits" of foreign corporations in which they hold stock and which are "organized in economically advanced countries." At the same time, the President recommended "elimination of the tax haven device anywhere in the world."

The Ways and Means Committee and the House of Representatives moved resolutely, if not altogether perfectly, in the direction indicated by the President.

The Finance Committee, on the other hand, in executive session, by rollcall vote, refused even to consider the President's major recommendations in this area. Instead, the committee proceeded to adopt a watered down tax haven approach to this problem, and then, amendment by amendment, moved further to weaken even that wholly inadequate approach—this, despite the fact that the Secretary of the Treasury had agreed, in testimony before the committee, that anything short of removal of the deferral privilege, whereby U.S. taxation of profits earned abroad may be indefinitely postponed, would be but "piddling" with the problem.

Though the committee has done a fairly creditable job in reviewing and acting on many provisions in the foreign area contained in the House-passed bill, it has materially weakened the grossup provision, section 9, and section 11, which deals with earned income from sources outside the United States. These provisions badly need strengthening. By far the most important provisions, however, are contained in section 12 dealing with controlled foreign corporations. It is here the Senate must surely act if this bill is to come even close to implementing the President's recommendations.

II

TAXATION AND CAPITAL FLOWS

One of the most startling economic phenomena of the past 5 years is the large-scale movement of American capital abroad. Though some of the economic activity represented by this movement may be desirable and may serve to increase exports, much of it directly and materially weakens the base of our economy. Some of this capital is drawn abroad for legitimate economic reasons. Much of it, far too much, is stimulated to move abroad because of faulty United States tax provisions.

Several reasons exist, of course, for this unprecendented movement of capital abroad. International barriers of all sorts are being broken down. Convertibility of currency exists in large measure. Electronic communications insure effective control of economic activities anywhere in the world from one central office. The movement of persons and goods has been speeded up and cheapened to a point where distance makes very little difference. American economic style and business organization have made American know-how welcome in most countries. American free world leadership has lent prestige to all things American.

In view of these facts—facts which we may not want to alter, even if we could—it is most inappropriate to set up additional artificial stimuli to the movement of American capital abroad, particularly into activities and in amounts which are contrary to the national interest. Existing law relating to the taxation of economic activities carried out by American interests in foreign countries constitutes just such an artificial stimulus to the movement of capital abroad into areas and activities which pose dangers to the domestic economy and make more difficult a solution of the balance-of-payments problem.

As our tax laws now stand, they constitute a positive subsidy to the movement of American capital abroad. There are numerous ways in which the taxation of profits from foreign operations can be reduced to the extent that it may be more profitable to expend American capital and American know-how in building up the economy of West Germany rather than the economy of West Virginia, or south Italy rather than South Carolina.

The existence of this unhappy circumstance is given implicit verification by virtue of the fact that this bill, in 11 of its 27 sections, deals with the taxation of foreign operations of U.S. taxpayers, both individual and corporate. Unfortunately, having recognized the existence of certain problems, the bill proceeds toward correction of these problems in a most timid and half-hearted manner.

Our tax laws regarding foreign operations are hopelessly out of date. For the most part they stem from rules laid down when the income tax was developed prior to the First World War. Developments in communications, transportation, and even in international politics and political organization have made some of these laws obsolete.

In theory, the United States taxes its citizens wherever they are and from whatever source their income is derived. Although this would seem to preclude the use of the tax laws as a subsidy to draw economic activity abroad, in practice we have nullified theory to a great extent by, first, allowing American interests to operate abroad in subsidiary form without the imposition of any U.S. taxation whatsoever on the profits from those operations until those profits are remitted—often in a form which can take a capital gains rate or no rate at all—and, second, by providing for a credit for foreign income taxes paid against ultimate U.S. taxes on income earned abroad.

It is now well past the time when we should have examined our basic concepts and tax laws in the light of current political and economic realities. It is well past the time when we should have given serious consideration to the need for continuing, through domestic tax law, the subsidization of the strengthening of the economies of the countries of Western Europe, Japan, Canada, and other countries which are, at least for the moment, our political allies and friends, but which are now, and in the foreseeable future will continue to be, our fierce economic competitors.

In reexamining our tax laws relating to foreign economic activities, there are three considerations which must, in the light of today's conditions, be kept in mind. These are (1) equity, always important to any tax system but doubly so in a voluntary system such as ours, (2) domestic economic health, particularly in these times of persistently high unemployment, and (3) the balance of payments.

III

TAX EQUITY

Equity in taxation is a subject to which lipservice is paid from time to time. Everyone claims to be in favor of equity, but many define equity in strange and tortured ways. Generally speaking, if a dollar earned by a particular type of taxpayer in any economic activity, in any geographical area, pays the same tax as another dollar earned under other circumstances by similar types of taxpayers we can say that tax equity has been achieved.

Of course, from time to time preferences are given to certain types of operations, certain areas, and certain organizations, but when this is done it should be done consciously, and deliberately, in the full knowledge of what is being done, and with the accomplishment of definite objectives in mind. When a subsidy is voted—and a subsidy can be awarded a taxpayer by giving him a tax preference just as surely as it can be awarded by way of a cash payment—it should be voted to accomplish a proper national or social goal, not done accidentally, or as a private giveaway.

For example, there is no question that the average homeowner receives better tax treatment than the average renter of living quarters. But the Congress has deliberately provided this because it is considered socially desirable to foster homeownership.

In certain other instances tax advantages are given inadvertently, or because of reasons which are no longer valid. Certain of our laws dealing with the taxation of the profits and income earned abroad by American taxpayers, both corporate and individual, directly and through technically foreign subsidiaries, fall in each of these two categories.

Business decisions today are often made on the basis of tax consequences. Many decisions as to what operations should be moved abroad are made on the basis of tax consequences. Many foreign operations are set up in order to avoid taxes, in a virtual maze of interlocking and overlapping organizations, confusing to customers and operators alike. This is hardly in keeping with concepts of equity or even good business management.

The best way to achieve tax equity, particularly in this field, is to seek tax neutrality, that is, to seek to have tax laws such that economic decisions are made on the basis of economic criteria, not on tax consequences. Unfortunately, the bill reported by the Finance Committee, although it recognizes the existence of inequity, does little to deal with it effectively. Under terms of this bill, operations carried on abroad will still receive favored tax treatment as compared with the same type of operation carried on here at home.

IV

DOMESTIC ECONOMIC HEALTH

It has been clearly recognized by government at all levels—Federal, State, and local—as well as by foreign governments, that taxation and tax differentials influence economic decisions. For that reason, we have seen some of our State and local government units offer various types of tax concessions when negotiating with industries to relocate. Some foreign governments have made concessions, including allowing new concerns to operate tax free for a specified number of years. The results of this type of stimulus can be clearly seen in Puerto Rico.

When the United States arbitrarily and unilaterally gives tax concessions to domestic industry, provided that industry will move abroad, the results are certainly foreseeable—and we are seeing them now. The end result is the weakening of our economy. But for some reason, many seem to feel that loss of capital and productive facilities is good for the United States, although bad for other countries.

The tax stimulus to the movement of productive facilities abroad is a subject which has been widely discussed for some years. For example, a study made by the American Management Association in 1960, and reported in Business Week for December 31, 1960, showed that, "because of tax differentials, the reinvestment of foreign earnings over a 3-year period can provide 'roughly double the rate of profit accumulation for reinvestment that is possible under domestic tax schedules.' "

With 52 percent domestic corporate tax rate, and with tax-haven countries having rates running down almost to zero in some instances on sales, service, and holding company income originating in third countries, the temptation to move facilities abroad, accumulate profits for reinvestment for a period of years, and only then begin to repatriate dividends on which an inadequate U.S. tax would finally be paid, could hardly be resisted. In fact it has not been resisted and we have seen a rapid acceleration of the buildup of American direct investment abroad during the past 5 years.

Our total private investment abroad now exceeds $50 billion, and is increasing at the rate of about $5 billion per year. In the field of direct investment, and particularly with reference to tax-haven devices it is noteworthy that, according to some authorities, two-thirds of our tax-haven companies have been established within the past 5 years.

The movement of productive facilities abroad has already reached serious proportions, but even more alarming is the increasing tempo of this movement. The loss of jobs, the loss of productive facilities needed for defense and other purposes, cannot be taken lightly. It is altogether too easy for a manufacturer, when he is faced with a labor problem or with extensive replacement of machinery, to pull up stakes and move a large part of his production to a foreign country.

In this country, contrary to the practice everywhere else in the world, the direct regulation of the outflow of capital and productive facilities has always been resisted. Such direct regulation may be necessary if we are to reach a real solution. But at the very least, we must not directly and positively encourage such an outflow by giving tax concessions to those who operate abroad and thereby build up the economies of foreign countries while tearing down our own. At the very least, we should remove the tax incentive which now exists to go abroad.

There will be, even with the enactment of the tightest possible tax provisions, a continuing flow of direct investment capital and productive facilities abroad in response to economic stimuli. This will not be interfered with by this, or any other similar bill. There will also be a continuation of the outflow of other forms of capital—portfolio and short-term. These latter outflows have been troublesome during the past few years and require direct and specific regulation. This bill touches only direct investment, and touches that ever so tenderly.

Criticism has been leveled at those who wish to remove the tax incentive to take American industry and productive facilities abroad. It has been alleged that this is a new type of protectionism—a new type of isolationism.

This criticism is unwarranted, and represents the most blatant type of reverse doublethink. There is no thought, insofar as this legislation is concerned, of doing anything more than removing a positive stimulus and subsidy for American plants to be moved abroad. Of course, it may well be that this is not enough. It may be that tax neutrality may not be sufficient to slow to a tolerable rate this widespread movement of capital abroad.

Those who believe in freer trade, and who support in general the President's recommendations for legislation to improve our reciprocal trade system which has served us so well for the past 28 years, certainly cannot legitimately be accused of economic isolationism merely because they wish to achieve tax neutrality, and terminate a hurtful subsidy.

The most cruel competition which an American producer can be forced to undergo is competition from American-type goods with well-known American brand names, produced abroad by American-owned subsidiaries which have achieved rapid growth because of the ability to dodge U.S. taxes and plow back practically all earnings, with these products distributed throughout this country through a well-established chain of wholesale and retail outlets. With a further lowering of tariffs contemplated by the trade bill now before the Finance Committee, it is certainly most inequitable to continue to give these foreign, but American-owned, producers continued tax advantages when they are competing directly with U.S. production, either in American or in foreign markets.

V

BALANCE OF PAYMENTS

It has become so fashionable to discuss any problem in terms of its effect on the balance of payments that one might properly look with suspicion on some arguments which attempt to tie balance-of-payments considerations to any possible subject matter. This has been much overdone. In the case of legislation directly affecting the flow of capital funds abroad, however, balance-of-payments considerations are certainly pertinent.

The balance-of-payments problem has been with us for some years, but has been recognized as being acute by the general public—and most Government officials—for only about the past 3 years. Prior to that time, many still talked of the dollar gap and of means of increasing the flow of capital abroad.

Although the balance-of-payments problem seems likely to be brought under control within the near future—and it must be brought under control within the next 2 or 3 years if we are to be able to avoid the use of rather drastic control methods—the problem is still acute and must be attacked from all quarters. This includes, but is not limited to, a close examination of investments made abroad by U.S. taxpayers. Those sections of the bill dealing with the taxation of profits gained from activities carried on abroad by American taxpayers will affect the balance of payments specifically and directly.

There are three principal types of capital outflows which are of concern in the balance of payments picture. Only one, that is, direct investment outflows, will be affected by the provisions of this bill. The other two, portfolio investment and short-term flows, will be little affected and must probably be dealt with in ways other than tax changes. The simplest way to deal with all three, of course, is by some system of direct licensing of capital outflows. Since we have traditionally resisted this type of regulation, however, we must be doubly sure that our tax laws are not weighted in the wrong direction. This bill does not go far enough in that regard. It does not subject income and profits earned abroad to as heavy an income tax as income and profits earned in the United States. But it does move, though haltingly and timidly, in the right direction.

There can be no question as to the effect of capital outflows on the balance of payments in the short run. There can be, of course, some question as to the long-range effects of capital outflows, particularly direct investment flows.

As to the long-range effect of direct investment outflows, the effect on the balance of payments may eventually be positive. But, with an acute situation which must be corrected within 2 or 3 years, it is not advisable to wait for a period of years, perhaps as long as 12 to 15 years according to Treasury Department analyses, for current direct foreign investment to assist in correcting the present imbalance.

Bearing in mind that direct foreign investment is accelerating, and that the net overall balance of payments deficit this year is expected to be in the neighborhood of $1.5 billion, an alteration of investment flows in the order of a few hundred million dollars would be significant.

Reliable estimates indicate that the complete removal of the deferral privilege would, by slowing down direct investment outflows and by speeding up repatriation of earnings, decrease the balance-of-payments deficit by about $400 million annually. This bill, of course, would not be nearly so beneficial. In its present from it would be of little assistance. A good, tight, tax haven bill would assist in the balance of payments in the order of $200 to $300 million.

VI

SPECIFIC PROVISIONS

The best and indeed the only sure way to achieve substantial equity, guard against the untoward weakening of American industry and assist in the solution of the balance-of-payments problem through taxation is to tax American taxpayers annually on income and profits earned anywhere in the world. This would restore neutrality as to taxation, allowing economic forces to play their proper role in economic decisions relating to investment choices at home or abroad. This would insure that the corporation which helps to build up a depressed area in the United States would be treated as fairly by the Federal Government as the corporation which builds up the economy of Western Europe. The most important section of the subject bill dealing with foreign operations has, however, been drawn up on the theory that the partial elimination of tax haven advantages is sufficient.

There is no question that the complete elimination of tax haven operations would help materially. It is through the combination of a sales subsidiary, a service subsidiary, and a holding company located in a tax haven country, Switzerland, for example, that the U.S.-owned manufacturing company in Germany—or other relatively high-tax foreign country—is able to reduce its German tax to a rate well below the stated rate of 51 percent. If tax havens are made less profitable from a tax standpoint, the manufacturing operations which support them will have to be justified on economic grounds, not on grounds of tax avoidance, whether the taxes avoided are United States or foreign.

The Finance Committee, by approving even these imperfect provisions, does recognize that certain changes in existing law should be made.

1. It is recognized that numerous abuses exist in the operation of certain types of corporations organized in certain low-tax countries. While this tax haven problem is recognized, it is not completely corrected.

2. It is recognized that many individual U.S. citizens are living abroad for the purpose, or with the result, of escaping proper U.S. taxation. But the provisions of the bill are insufficient to deal with the problem. It will still be highly profitable, under the terms of this bill,

for a U.S. citizen to live abroad and thereby avoid paying his fair share of the cost of U.S. and free world defense and essential Government services.

3. It is recognized that there are numerous abuses in setting up foreign trusts for the purpose of escaping U.S. taxation.

4. It is recognized that there have been abuses in the liquidation of foreign corporations, with the result that accumulated ordinary income is being brought into the country in a form which allows it to be taxed at the low capital gains rate, if at all.

5. It is recognized that the U.S. estate tax has been avoided by some through the device of investing in foreign real estate, even in contemplation of death.

6. It is recognized that the law as now written allows both a partial credit and a deduction for foreign income and related taxes. For some reason, presumably because it is recognized that tax reductions do act as subsidies to draw capital investment abroad, the committee allows this double benefit to be continued in less developed countries.

7. It is recognized that present law does not require sufficiently stringent reporting of foreign economic activities of American interests.

In order for the bill to be really meaningful in correcting the imperfections in existing law which have been recognized, however, certain minimum changes must be made.

1. Section 12—Controlled foreign corporations

(*a*) This entire section, embodying as it does the tax haven approach, ought to be deleted and have substituted therefor the complete removal of the deferral privilege. Language to accomplish this objective exists in amendment 6–19–62——A to H.R. 10650, previously offered.

(*b*) The tax haven approach, if sufficiently rigorous, does represent a step forward. Should the Senate decide to proceed with this approach, this section should be amended in at least the following ways:

(1) The de minimus rule should be restored to 20 percent.

(2) The exception for export trade income of "Export Trade Corporations" should be deleted.

(3) The exception for dividend and interest income from less developed countries, together with profits realized from the sale of investments in less developed countries, should be deleted.

2. Section 9—The gross-up

This provision should be made applicable to income from subsidiary corporations operating anywhere in the world, as provided by the House-passed bill. There is no equity in allowing both a deduction and a partial credit for income taxes paid to certain countries. The operation of existing law in this area is capricious and even perverse, and is not a suitable vehicle for a subsidy, should it be felt that a subsidy is needed or desirable.

3. Section 11—Income earned abroad

There is no equity in allowing individual U.S. citizens living abroad, either temporarily or on a more permanent bona fide basis, to pay less taxes than citizens and residents here at home. All benefit from services rendered by both the U.S. Government and the government of their host countries. All should contribute toward the cost of U.S. and free world protection. It is particularly inappropriate to allow a phasing-in of taxes on fringe benefits.

CONCLUSIONS

On balance, the bill as reported by the Finance Committee is a poor one. Although there are worthwhile sections in the bill these are hardly sufficient to outweigh those sections which are, either in whole or in part, faulty.

As we have already pointed out, many of the President's major recommendations have been ignored or watered down. The committee has chosen to strike the withholding provision, which was passed by the other body. It has failed to include in the bill such obviously needed reforms as the repeal of the dividend credit and exclusion as recommended by the President. In almost every instance, expense accounts and foreign operations, for example, where the committee did approve a section or provision recommended by the President and adopted by the House, that provision has been materially weakened.

As if the emasculation of many of the President's major recommendations were not enough, the Finance Committee has added, by way of afterthought, several rather petty addenda to the bill. Sections 21 through 26 really have no place in this bill. Some of these additions are really private bills masquerading as general legislation, while others are of such minor consequence that they have far too little stature to warrant their consideration in this bill when so many more important subjects are being left to a later, more general, tax reform bill. Some of these sections, indeed, standing alone are hardly veto proof.

The Senate must now proceed to a painstaking examination of each provision contained in this bill. We would hope that there will be full and free debate on all provisions and that each individual Senator will examine all provisions and all amendments which will be offered with care and join in an earnest endeavor to put this bill in a form more closely resembling the President's recommendations.

Should the Senate or the conference committee fail to make substantial improvements, it will be our painful duty, despite the worthwhile provisions which are contained in this bill, to oppose its final passage.

PAUL H. DOUGLAS.
ALBERT GORE.

O