AMENDING THE REVENUE ACT OF 1918

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

SIXTY-SIXTH CONGRESS
SECOND SESSION

ON

H. R. 14197 and H. R. 14198

TO AMEND THE REVENUE ACT
OF 1918

MAY 31, 1920

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AMENDING REVENUE ACT OF 1918.

MONDAY, MAY 31, 1920.

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

The committee met pursuant to call at 11.30 o'clock a. m., in the committee room, Capitol, Senator P. J. McCumber presiding.

Present: Senators McCumber (chairman), Smoot, Dillingham, Calder, Sutherland, Curtis, McLean, Simmons, Thomas, and Nugent.

The CHAIRMAN. The committee will be in order.

The committee has under consideration House bills H. R. 14197 and H. R. 14198, which will be printed in full in the record.

(The bills referred to are here printed in full as follows:)

H. R. 14197, Sixty-sixth Congress, Second Session.

AN ACT To amend the personal service corporation provisions of the Revenue Act of 1918, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 201 of the Revenue Act of 1918 is amended to read as follows:

"SEC. 201. (a) That the term 'dividend' when used in this title (except in paragraph (10) of subdivision (a) of section 234) means (1) any distribution made by a corporation to its shareholders or members, whether in cash or in other property, out of its earnings or profits accumulated since February 28, 1913.

"(b) Any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. Any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated prior to March 1, 1913, may be distributed, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.

"(c) A dividend paid in stock of the corporation (hereinafter called 'stock dividend') shall not be subject to tax at the time of distribution. Amounts bona fide distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits.

"(d) A distribution shall be deemed to have been made by a corporation to its stockholders or members as of the date when the cash or other property is so distributed or set apart for or credited to the account of such stockholders or members as to be unqualifiedly subject to their immediate demands, and shall be taxed to such stockholders or members as of the date of such distribution.

"(e) For the purpose of computing the invested capital of a corporation, dividends distributed by such corporation during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits; and if the books of the corporation do not show the amount of such earnings or profits, the

earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period."

SEC. 2. That section 205 of such Act is amended as follows:

(1) In the first paragraph of subdivision (a) strike out the colon and the following:

"*Provided*, That in the case of a personal service corporation the amount to be paid shall be only that specified in clause (1)."

(2) In the second paragraph of subdivision (a) strike out the words "or, in the case of a personal service corporation, the amount specified in clause (1)" and the comma.

(3) In subdivision (c) strike out the colon and the following:

"*Provided*, That in the case of a personal service corporation with respect to a fiscal year beginning in 1917 and ending in 1918, the amount specified in clause (1) shall not be subject to normal tax."

SEC. 3. That subdivision (a) of section 216 of such Act is amended to read as follows:

"(a) The amount received as dividends from a corporation which is taxable under this title upon its net income;"

SEC. 4. That subdivision (e) of section 218 of such Act is repealed.

SEC. 5. That paragraph 14 of section 231 of such Act is repealed.

SEC. 6. That paragraph 6 of subdivision (a) of section 234 of such Act is amended to read as follows:

"(6) Amounts received as dividends from a corporation which is taxable under this title upon its net income;"

SEC. 7. That section 301 of the Revenue Act of 1918 is hereby amended—

(1) By inserting after the word "corporation" in subdivision (a) the words "(except a personal service corporation)";

(2) By inserting after the word "except" in subdivision (b) the words "personal service corporations and"; and

(3) By inserting after the word "corporation" in subdivision (c) the words "(except a personal service corporation)."

SEC. 8. That section 335 of such Act is amended as follows:

(1) In subdivision (a) strike out the following: "(other than a personal service corporation.)"

(2) In the first paragraph of subdivision (c) strike out the words "or a personal service corporation."

(3) In the second paragraph of subdivision (c) strike out the words "or personal service corporation" and the words "or corporation."

SEC. 9. That in addition to all other taxes, there shall be levied, collected and paid for the taxable year 1920 upon the net income of every personal service corporation received or accrued during the taxable years 1918 and 1919 a tax equal to the tax that would have been paid had such corporations been subject to the taxes imposed by section 230 of the Revenue Act of 1918 for such years.

SEC. 10. (a) That in addition to all other taxes and in addition to the tax imposed by section 9 there shall be levied, collected, and paid for the taxable year 1920 upon the net income of every personal service corporation a tax equal to the sum of (1) 30 per centum of the amount of the net income of such corporation for the taxable year 1918 in excess of the dividend credit determined for that year under paragraph (c) of this section and (2) 20 per centum of the amount of the net income of such corporation for the taxable year 1919 in excess of the dividend credit determined for that year under paragraph (c) of this section.

(b) For the taxable year 1920 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every personal service corporation a tax equal to 20 per centum of the amount of the net income in excess of the dividend credit determined under paragraph (c) of this section.

(c) The dividend credit shall consist of a specific exemption of $3,000 plus the amount by which the dividend distributed by the corporation to its stockholders or members during the taxable year exceeds the dividends deducted under the provisions of section 234 of the Revenue Act of 1918.

A foreign corporation shall not be entitled to the specific exemption of $3,000.

(d) Any personal service corporation that elects to pay taxes for the taxable years 1918 and 1919 under the provisions of the Revenue Act of 1918 as provided in section 11 of this Act shall not be subject to the taxes imposed by section 9 or subdivision (a) of this section nor shall it be required to make return in respect to such taxes.

SEC. 11. That the taxes imposed by sections 9 and 10 shall be returned, assessed, collected, and paid, upon the same basis, in the same manner, and subject to the same provisions of law, including penalties, as the taxes imposed by Title II of the Revenue Act of 1918.

The taxes imposed for the taxable year 1920 shall be returned, assessed, collected, and paid at the time provided in Title II of the Revenue Act of 1918 for the return and payment of income taxes for the taxable year 1920; and the tax imposed for the taxable year 1921 and each taxable year thereafter shall be returned, assessed, collected, and paid at the time provided in Title II of the Revenue Act of 1918 for the return and payment of income taxes for the taxable year 1921 and each taxable year thereafter.

All terms used in sections 9, 10, and 11 of this Act shall have the same meaning as the like terms used in the Revenue Act of 1918.

SEC. 12. That the stockholders of any personal service corporation in existence in the taxable year 1918 or 1919, by a written agreement between the directors of the corporation and all the stockholders thereof, may for such years elect to be taxed under the provisions of the Revenue Act of 1918 in effect prior to the time this Act takes effect; and in the case of any personal service corporation the stockholders and the directors of which have made such election, any distribution made hereafter from earnings or profits accumulated during the calendar years 1918 and 1919 shall be exempt from the tax imposed by Title II of the Revenue Act of 1918: *Provided further*, That such directors and stockholders shall be deemed to have made such agreement and election unless within ninety days after the time this Act takes effect one or more of them shall have notified the commissioner in writing that he rejects such agreement and election.

The Commissioner of Internal Revenue shall mail to all personal service corporations at the last known address a copy of this Act within 30 days after the same takes effect.

H. R. 14108. SIXTY-SIXTH CONGRESS, SECOND SESSION.

AN ACT To amend and simplify the Revenue Act of 1918.

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

BASIS FOR DETERMINING GAIN OR LOSS.

That subdivision (a) of section 202 of the Revenue Act of 1918 is amended to read as follows:

"(a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

"(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property, as of that date;

"(2) In the case of property acquired (except by gift, bequest, devise, or descent) on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203;

"(3) In the case of property acquired by gift since February 28, 1913, the same basis that it would have in the hands of the donor or the last preceding owner, by whom it was not acquired by gift;

"(4) In the case of the sale or exchange of property acquired by gift, the entire amount received therefor shall be included in the gross income of the donee, unless the donee submits with his return evidence satisfactory to the commissioner showing the basis in the hands of the last preceding owner who acquired the property other than by gift; and

"(5) In the case of property acquired after February 28, 1913, by bequest, devise, or descent, the fair market price or value of such property on the date of acquisition."

SEC. 2. That section 202 of such Act is amended by adding at the end thereof a new subdivision to read as follows:

"(c) In the case of stock dividends paid after February 28, 1913, the cost to the taxpayer of each share of old and new stock shall be the cost of the old shares of stock (or the market price or value thereof as of March 1, 1913, if acquired prior thereto) divided by the total number of old and new shares

of stock: *Provided*, That in cases in which the old and new shares of stock differ materially in character or preference, the cost of the old shares of stock (or the market price or value thereof as of March 1, 1913, if acquired prior thereto) shall be apportioned between the old and new shares of stock as nearly as may be in proportion to the respective value of each at the time the new shares of stock were acquired."

SEC. 3. That Title II of such Act is amended by adding at the end of part I thereof the following new section:

EXTRAORDINARY NET INCOME.

"SEC. 207. (a) That compensation received in any taxable year beginning after December 31, 1919, for personal service rendered by the taxpayer during a period of more than three years, and gain derived in any such year from the sale of capital assets acquired more than three years prior to the date of sale, shall be deemed to be extraordinary income; and such income, less losses of the same class or description and the expenses or other deductions properly chargeable thereto, shall be deemed to be extraordinary net income.

"(b) The terms 'capital assets' as used in this section includes (but is not limited to) property held by the taxpayer for consumption or use; but does not include any property, whether real, personal, or mixed, held by a dealer for sale or included in the inventory of the taxpayer taken at the close of the preceding taxable year. The terms 'compensation received' and 'gain derived' mean compensation or gain accrued in the case of taxpayers who make returns upon the so-called accrual basis; but the provisions of this section shall not apply in the case of sales upon the installment plan when the income or gain is accounted for in installments as the payments are received.

"(c) If the extraordinary income of a taxpayer amounts to more than 20 per centum of his entire gross income for the taxable year, the extraordinary net income for such year may at his option be apportioned ratably to the years or parts thereof during which such service was rendered or such assets held (or to the years or parts thereof between February 28, 1913, and the date of sale, if such assets were acquired prior to March 1, 1913); and the amount thus ratably apportioned to any year shall be added to the other income of the taxpayer for such year and the tax redetermined upon the corrected amount at the rates applicable to such year, notwithstanding the provisions of section 206 or any other provision of this Act. A return or returns of such extraordinary income shall be made at the time prescribed in subdivision (a) of section 227 in such manner and with such information as the commissioner, with the approval of the Secretary, may by regulations prescribe; and if the additional taxes found upon such redetermination to be due for prior years are paid in the same proportionate amounts and at the same installment dates fixed for the payment of taxes due upon income for the year in which such extraordinary income was received, no penalty or interest shall be added with respect to the time which has elapsed between such prior years and the date or dates of payment."

ASSESSMENT AND COLLECTION OF TAXES.

SEC. 4. That subdivision (d) of section 250 of such Act is amended to read as follows:

"(d) The amount of tax due under any return made under this or prior Acts shall be determined and assessed by the commissioner within five years after the return was made, except (1) in the case of false or fraudulent returns with intent to evade the tax, or (2) with the consent of both the commissioner and the taxpayer, or (3) as otherwise provided in section 207, or in paragraph (9) of subdivision (a) of section 214, or in paragraph (8) of section 234, or (4) in the final settlement of losses and other deductions tentatively allowed by the commissioner pending a determination of the exact amount deductible; and no suit or proceeding for the collection of any tax shall be begun after the expiration of five years after the date when the return was made. In the case of such false or fraudulent returns, the amount of the tax due may be determined at any time after the return is filed, and the tax may be collected at any time after it becomes due."

SEC. 5. That Title XIII of such Act is amended by adding at the end thereof two new sections to read as follows:

"SEC. 1321. That if after a determination and assessment in any case the taxpayer has without protest paid in whole any tax or penalty, or accepted

any abatement, credit, or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the commissioner, with the approval of the Secretary, that such determination and assessment shall be final and conclusive, then (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States, and (2) no suit, action, or proceeding to annul, modify, or set aside such determination or assessment shall be entertained by any court of the United States.

"SEC. 1322. That in case a regulation or Treasury decision made by the commissioner or the Secretary, or by the commissioner with the approval of the Secretary, is reversed by a subsequent regulation or Treasury decision, and such reversal is not immediately occasioned or required by an opinion of the Attorney General or a decision of a court of competent jurisdiction, such subsequent regulation or Treasury decision may, in the discretion of the commissioner, with the approval of the Secretary, be applied without retroactive effect."

LIBERTY BOND EXEMPTIONS.

SEC. 6. The various Acts authorizing the issues of Liberty bonds are amended and supplemented as follows:

(a) On and after January 1, 1920, 4 per centum and 4½ per centum Liberty bonds shall be exempt from graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States upon the income or profits of individuals, partnerships, corporations, or associations, in respect to the interest on aggregate principal amounts thereof as follows:

Until the expiration of two years after the date of the termination of the war between the United States and the German Government as fixed by Congress or by proclamation of the President, on $125,000 aggregate principal amount; and for three years more on $50,000 aggregate principal amount.

(b) The exemptions provided in subdivision (a) shall be in addition to the exemptions provided in section 7 of the Second Liberty Bond Act, and in addition to the exemption provided in subdivision (3) of secton 1 of the Supplement to the Second Liberty Bond Act in respect to bonds issued upon conversion of 3½ per centum bonds, but shall be in lieu of the exemptions provided and free from the conditions and limitations imposed in subdivisions (1) and (2) of secton 1 of the Supplement to Second Liberty Bond Act and in section 2 of the Victory Liberty Loan Act.

STATEMENT OF MR. JOHN E. WALKER.

Senator MCCUMBER. State your name, please.

Mr. WALKER. John E. Walker, Solicitor's Office, Internal Revenue I shall first discuss H. R. No. 14197, entitled "An act to amend the personal-service corporation provisions of the Revenue Act of 1918, and for other purposes."

It is designed to make certain that personal-service corporations are not exempted from income excess profits and war-profits taxes because of the stock dividend decision of March 8, 1920, in the Macomber case. In that decision the court made the following very broad statement:

But looking through the form, we can not disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon the stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets when they have none; and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder.

The Revenue Act of 1918 specifically provides that a personal service corporation shall be treated in the same manner as a partnership; that is, each member of the personal service corporation shall be liable to income taxes on his pro rata share of profits whether the same are distributed or not. This bill proposes to take out of the revenue act of 1918 all reference to personal service corporations, except the definition of a personal service corporation, and to provide a new method of treating income of personal service corporations for income tax purposes. This method is provided in sections 9 and 10 of the bill.

Senator SMOOT. Section 9 of what bill?

Mr. WALKER. H. R. 14197, page 5, on line 13. This section imposes a tax on personal service corporations for the taxable year 1920 equal to the income taxes that would have been paid by such corporations during the taxable years 1918 and 1919 had they been subject to the taxes imposed by section 230 of the revenue act of 1918 for such years. That means that the tax would be equal to the income tax that such corporations would have paid during the taxable years 1918 and 1919 had they been treated in the same manner as other corporations. By striking out of the revenue act of 1918 the reference to personal service corporations for the year 1920 and each year thereafter, personal service corporations will be liable for the 10 per cent corporation income tax. In other words, by striking out the reference to personal service corporations and by the enactment of section 9 into law, the personal service corporations, unless they take advantage of the election provided under section 12, will pay during 1920 a tax equal to the 12 per cent corporation income tax that it would have paid if it had paid the corporation income tax for 1918, a tax equal to 10 per cent upon its net income for 1919, and a 10 per cent income tax upon the net income for 1920 and for every year thereafter.

Senator SMOOT. Is that a retroactive income tax?

Mr. WALKER. It is. Section 12, however, provides that if a personal-service corporation elects to be treated under the provisions of the revenue act of 1918 as they now stand—it shall not be subject to the taxes imposed by sections 9 and 10.

Senator MCCUMBER. Now, explain why you propose this change.

Mr. WALKER. It is feared by the Treasury Department that the Supreme Court decision in the stock dividend case may exempt personal-service corporations from income and profits taxes if a personal-service corporation case is carried to the Supreme Court, and rather than let 2,500 corporations out of the payment of tax, the Treasury Department feels it is better to clear up that possibility of exemption from tax and place an equitable tax upon personal-service corporations.

Senator MCCUMBER. In other words, you are apprehensive that the Supreme Court will hold in the case of personal-service corporations that inasmuch as they are corporations that the stockholders can not be subjected to a tax upon the earnings not distributed.

Mr. WALKER. Yes, sir.

Because if they are not distributed they have not received any income and the revenue act of 1918 says personal-service corpora-

tions shall not be subject to corporation income tax under Title II, nor to excess profits and war profits taxes under Title III.

Now, section 10 proposes retroactive taxes upon the undistributed profits of corporations for 1918 and 1919 in lieu of the excess-profit and war-profits taxes. The House selected these two rates on the basis provided in section 302 of the revenue act of 1918 in the case of small corporations. That act, in the case of small corporations, provides that for 1918 the excess-profit tax shall not be in excess of 30 per cent of the net income, and after 1918 in excess of 20 per cent. Now, section 10 of this bill provides that for the taxable year 1920 if a personal service corporation does not elect to let its tax payments stand under the 1918 act, it shall pay a tax, in lieu of the excess-profit tax for the taxable year 1918 of 30 per cent upon its undistributed profit for the taxable year 1918, and a tax of 20 per cent upon the undistributed profit for the taxable year 1919. Section 10 also imposes a tax of 20 per cent upon the undistributed profits of personal service corporations for the taxable year 1920 and each year thereafter.

Senator SMOOT. These personal service corporations have had a very hard time to live during the year, and now with the retroactive tax which you have just described will it not drive them out of business?

Mr. WALKER. No, Senator, they have their election, and if they elect under section 12 of this bill to let their tax returns stand as they have made them under the revenue act of 1918, they are not subject to pay the tax proposed in this bill for the taxable years 1918 and 1919.

Senator SMOOT. This was one of the most difficult questions before the Finance Committee when this act of 1918 was before us, and it resolved itself into this situation: That if we impose upon these personal service corporations the regular taxes imposed on other corporations, there would not be 10 per cent of them that could exist in the United States.

Mr. WALKER. Yes, sir.

Senator SMOOT. At that time they were all struggling to secure money to keep in operation, and I think we gave more time to hearings on the part of those interested in personal service corporations than on any other subject of the revenue bill. Now this bill provides, by section 12, that they must now accept the revenue law of 1918 and pay taxes under it for the taxable years 1918 and 1919 or pay the taxes imposed by the proposed bill for such years.

Mr. WALKER. The stockholders have already paid the taxes for 1918 and 1919.

Senator SMOOT. Yes, but now they have to pay not only the taxes provided in that revenue bill but have to pay the taxes imposed upon the regular corporations of the country or else pay this retroactive tax.

Mr. WALKER. No, not that, Senator. This is the case: Under section 12 they can elect to pay taxes under this bill for 1918 or 1919 or to let their returns that they have already made, and the taxes that their stockholders have already paid, stand.

Senator SMOOT. Well, they have to pay the taxes imposed under the revenue act of 1918.

Senator SUTHERLAND. They have already paid them.

Mr. WALKER. But the Supreme Court having said so flatly you can not look through the corporate entity in the case of corporations and impose on the stockholders a tax on the profits not distributed.

Senator SMOOT. In other words, the law means that they have got to pay the tax?

Senator MCCUMBER. I can not understand it that way. You can not call it retroactive. They have paid their taxes under the tax law.

Senator SMOOT. Under this law, they have to admit that any decision of the Supreme Court that may be had will not relieve them of the payment of the taxes that are imposed for 1918 and 1919, or if they do not do that they have to pay this retroactive tax.

Mr. WALKER. That is right, but of course the stockholders would be entitled to a refund on any taxes paid for 1918 and 1919 under the revenue act of 1918 on earnings not distributed.

Senator MCCUMBER. I think they should not be relieved from paying any tax nor should the Treasury Department be compelled to refund the taxes that have been paid in case the Supreme Court holds in the case of personal-service corporations that any undistributed earnings are untaxable.

Senator SMOOT. If you want to pass a law to head off a decision that the department expects now the Supreme Court will make, then pass section 12 of this bill. But here you are saying to those personal service corporations if you do not pay the tax irrespective of what the Supreme Court may decide, then you must pay a retroactive tax. Now that is the situation exactly.

Senator MCCUMBER. The stockholders have already paid the tax for 1918 and have probably paid at least one-fourth of the 1919 tax.

Senator SMOOT. But they have not paid the tax, Senator, if the decision of the Supreme Court is as the Treasury Department expects it to be.

Senator MCCUMBER. They have paid it, but would have the right to recover it back.

Senator SUTHERLAND. This would prevent them from getting it back and keep it in the Treasury.

Senator MCCUMBER. That is all there is to it.

Senator SUTHERLAND. If there was a loophole in the old law, this holds it.

Senator CURTIS. Do they pay the tax on the undistributed earnings for 1918?

Mr. WALKER. Those personal service corporations for 1918 and 1919 have paid their taxes in exactly the same way as members of partnerships. That is to say, the individual members or stockholders pay the tax on their pro rata share whether the income is distributed or not.

Senator SUTHERLAND. Then you want this bill passed so that they can not get a rebate from the Government if the Supreme Court decides in their favor?

Mr. WALKER. Yes, sir.

I would like to read you the Secretary's statement in his letter of March 17, 1920, to Mr. Fordney with reference to the personal service corporation situation.

PERSONAL-SERVICE CORPORATIONS.

Under the revenue act of 1918 personal-service corporations are treated substantially as partnerships—i. e., the corporation as such is exempt from income, profits, and capital-stock taxes, but stockholders are subject to both normal income tax and surtaxes upon their full distributive shares in the net income of the corporation whether such income is actually distributed or not. The validity of this procedure is involved in the gravest doubt by the doctrine enunciated in the stock-dividend case, which apparently leads to the conclusion that a stockholder of a corporation, particularly a minority stockholder, can not be taxed (without apportionment according to population) upon a share of the corporation's income which he has not actually received. It is possible, notwithstanding the above reasoning, that the present statutory method of dealing with personal-service corporations might be sustained on the ground that it represents in general, in its effects upon personal-service corporations and their stockholders as a class, a relief provision imposed in lieu of the excess-profits tax which is unsuited to personal-service corporations and if applied to them generally would in many cases work intolerable hardships. But this interesting question need not be discussed here. There is a grave possibility, if not probability, that the stock-dividend decision practically exempts from all income and profits taxation a group of approximately 2,500 corporations and their stockholders, who would pay under existing law—and should in fairness pay at least—from five to six million dollars. This possibility, with its consequent uncertainties, should plainly be removed by the passage of amendatory legislation.

Fortunately it is possible to place personal-service corporations and their stockholders in nearly the same position that they now occupy—in a manner wholly consistent with the spirit and letter of the ruling of the Supreme Court—by applying to such corporations on and after January 1, 1918, the tax on undistributed profits recommended above for all corporations on and after January 1, 1921. This tax would of course be in lieu of the war-profits and excess-profits tax which, because of its dependence upon "invested capital," can not intelligently be applied to personal-service corporations in which, by definition, "capital (whether invested or borrowed) is not a material income-producing factor." It is plain also that the law should be so amended as to tax dividends received by the stockholders of personal-service corporations in the same manner as other dividends are taxed.

It would be desirable, moreover, in my opinion, to permit personal-service corporations at their option to distribute during the year 1920 cash or other taxable dividends to the full extent of their profits earned during 1918 and 1919 but not yet distributed, and such retroactive distributions should be made taxable by the stockholders at the surtax rates applicable to the years in which the profits were accumulated by the corporation. By so doing personal-service corporations could, if they desired, place themselves and their stockholders in nearly the same position that they now occupy; i. e., they would pay no profits tax at all while the entire corporate income (having been distributed) would be taxable in the hands of the stockholders. Indeed, so closely would the proposed plan resemble in effect the method of taxing personal-service corporations prescribed in the Revenue Act of 1918 that it would be eminently proper—and probably a source of great convenience to the taxpayers concerned—to authorize personal-service corporations with the written consent of their stockholders to elect voluntarily to pay taxes for the years 1918 and 1919 on the basis prescribed in the revenue act of 1918.

* * * * * * *

There are about 2,500 personal-service corporations having net income of approximately $30,000,000 involved, the taxes upon which under existing law do not exceed $6,000,000 for the year 1918, and a slightly smaller amount for the year 1919. The aggregate loss for the two years, 1918 and 1919, would probably be between $10,000,000 and $12,000,000. The need for legislation in this connection arises not so much from the possible loss of revenue as from the obvious undesirability of permitting 2,500 corporations and their stockholders to escape both the taxes upon corporations and those imposed upon individuals.

Senator McCUMBER. It seems as though we must agree that if you tax corporations and partnerships and partnerships have paid

their tax on undistributed profits, we ought to hold personal service corporations to the same rule or else provide some other way to hold them.

Senator SUTHERLAND. That is what this does.

Senator MCCUMBER. I think this proposed legislation should be enacted into law.

Mr. WALKER. If you wish, I will be glad to take up each section.

Senator MCCUMBER. Go on.

Mr. WALKER. I have had the bill typewritten so that the present law is indicated in ordinary type. The matter proposed by the House bill to be eliminated is lined through, and any new matter proposed to be inserted is underlined. In section 1 of H. R. 14197, the only changes that are proposed in paragraph (A) of section 201 of the revenue act of 1918 are the striking out of the various references in that paragraph to personal service corporations.

In paragraph (b) the same is also true.

Paragraph (c) stated in the present law that a dividend paid in stock shall be considered income. Of course that no longer stands, so that this sentence has been rewritten as follows:

A dividend paid in stock of the corporation (hereinafter called "stock dividend") shall not be subject to tax at the time of distribution.

The only change in the next sentence is the insertion of the words "bona fide." That was thought advisable to make sure that the following case was included. It was feared a personal corporation might declare stock dividends before liquidating their assets and in that way avoid the payment of taxes upon the earned surplus.

Subdivision (d) of section 201 has no more use whatever. It relates only to stock dividends received between January 1 and November 1, 1919. It is suggested that a new subdivision (d) be substituted in order to settle the much contested point as to when a dividend declared to a stockholder is income in the hands of the stockholder. In the case of dividends declared toward the end of a taxable year, the question arises as to whether the dividend is income of that year or income of the succeeding year, and subdivision (d) merely incorporates the Treasury ruling to the effect that whenever a distribution is made so that the cash or other property is so set apart or credited to the stockholder as to be unqualifiedly subject to the immediate demands of the stockholder then it is income to the stockholder as of the date of such distribution.

The only change made in subdivision (e) is the insertion of the following words:

For the purpose of computing the invested capital of a corporation, dividends distributed by such corporation.

There has been some contention over the question when the earnings or profits accumulated in the preceding year of a corporation should be carried to invested capital of the corporation. The only use they made of subdivision (e) is for the determination of invested capital.

Senator SMOOT. This says for the purpose of computing the invested capital of a corporation, dividends distributed by such corporation during the first 60 days of any taxable year shall be deemed to have been made from earnings or profits accumulated during pre-

ceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits; and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period. Now you have added there to the existing law: "For the purpose of computing the invested capital of a corporation, dividends distributed by such corporation." Are you going to tax them hereafter?

Mr. WALKER. That provision fixes the rule for the determination of the invested capital of a corporation. If the earnings were distributed during the first 60 days of the taxable year, then the invested capital is reduced as of the date when the dividend is payable by the entire amount of the dividend so paid. This is exactly the present rule of the Treasury Department in such cases.

Senator SMOOT. You have held that in the administration of the present law?

Mr. WALKER. Yes, sir. That is the only use that has been made of this section.

Section 2, as you will note, amends section 205 of the Revenue Act of 1918 by eliminating all references to personal service corporations.

Section 3 likewise eliminates the reference to personal service corporations in subdivision (a) of section 216 of the revenue act of 1918.

Subdivision (e) of section 218 of the revenue act specifies the manner of treating the income of personal service corporations and the stockholders thereof for tax purposes, namely, like that of a partnership and the members thereof. Of course, in eliminating all reference to personal service corporations and treating them the same as a corporation there is no need for that provision, and it is therefore suggested in section 4 that the provision be repealed.

Section 5 of the bill repeals paragraph (14) of section 231 of the Revenue Act of 1918.

This section specifies the corporations that are exempt from income tax and of course if you are going to treat personal service corporations for income tax purposes as other corporations, personal service corporations must be eliminated from section 231.

Section 6 eliminates all reference to personal service corporations in the dividend deduction provision of paragraph (6) of subdivision (a) of section 234 of the revenue act.

Section 7 proposes the insertion of the words "except a personal service corporation" in the three places where reference is made to the imposition of the excess profits tax on corporations.

Section 10 of this bill proposes to place a tax on the undistributed profits of the corporation in lieu of the excess profits tax. So it is necessary in section 301 to exempt personal service corporations from the excess profits tax.

Section 8 provides for the striking out of the reference to personal service corporations where it appears in three instances in section 335 of the Revenue Act of 1918.

Sections 9 and 10 relate to the taxation of personal service corporations, which I have gone over.

Section 11 relates to the assessment and collection of these taxes. In 1920, should this bill be enacted into law, the personal service corporation will make the return for 1918, 1919, and 1920 at the same time that other corporations make tax returns for 1920, and pay the taxes in four monthly installments in the same manner as other corporations.

Section 12 is the optional provision which I have already referred to.

Is there any further question with reference to this bill?

Senator McCUMBER. I don't know of any. We will then consider act H. R. 14198.

Mr. WALKER. H. R. 14198, entitled "An act to amend and simplify the Revenue Act of 1918," contains six principal features. The change in existing law proposed by section 1 is deemed necessary to make it impossible for taxpayers to turn over their property to friends or relatives for sale in order to evade paying income taxes upon the appreciation in value during the time the same was held by the original owner.

Section 2 lays down the rule which is now covered by the regulations for determining the basis of computing the income tax in the case of the sale of stock with respect to which a stock dividend has been declared, or in the case of the sale of stock received as a stock dividend.

Section 3 changes the basis of computing income in the case of compensation received in one year for personal services rendered during a period of over three years, or in the case of income received in one year from the sale of capital assets which have been held for a greater period than three years. The provision in section 3 provides that in case the compensation for personal services is received in one year or the gain from the sale of assets is received in one year, such gain may be allocated over the period of years over which the services were rendered or in which the appreciation has occurred. It is believed this section is fairer than the present section making the gain subject to tax in the year in which it is received and that at the same time it will greatly increase the revenue, especially because of the great amount of sales that are now held up because the taxpayer believes he can not afford to make the sale on account of the large amount of the gain that he would have to give up in taxes.

Senator SMOOT. If you will take that bill I would like to ask some questions on sections 1 and 2 of the bill. In section 1 under subhead 5 on page 2, the House put in there:

> In the case of property acquired after February 28, 1913, by bequest, devise, or descent, the fair market price or value of such property on the date of acquisition.

If you make that change up in paragraph 3 of section 1 by striking out the word "in" and insert "After December 31, 1918," you certainly could make that change in subdivision 5 and strike out that provision that the House put in.

Mr. WALKER. That is not necessary.

Senator SMOOT. As to the property acquired after February 28, 1913.

Mr. WALKER. That is not necessary because that provision does not change the present basis. The present basis in the case of sale of

property, acquired by bequest, devise, or descent, is the fair market price or value of such property on the date of acquisition, or the fair market value on March 1, 1913, if the property was acquired prior thereto.

Senator SMOOT. This applies only to the property acquired by gift.

Mr. WALKER. No; subdivision 5 only applies to property acquired by bequest, devise, or descent.

Senator THOMAS. Subdivision 3, "in the case of property acquired by gift since February 28, 1913, the same basis that it would have in the hands of the donor or the last preceding owner, by whom it was not acquired by gift;" that means that if I give you property, it is not subject to tax, but if you sell it, then the difference between the values is taxable.

Mr. WALKER. Yes, sir.

Senator MCCUMBER. Under the present law the basis provided in paragraph (3) would apply unless the gift was made in good faith. Paragraph (3) makes the value in the hands of the donor the basis whether the gift is made in good faith or not, doesn't it?

Mr. WALKER. Yes, sir.

Senator MCCUMBER. So it eliminates the necessity of ascertaining whether or not it is a bona fide gift.

Senator SMOOT. I don't see why you want to go back to February 28, 1913.

Mr. WALKER. That is the basic date for the determination of gain in the case of property acquired prior to the ratification of the income-tax amendment to the Constitution.

Senator SMOOT. But you say in the case of property acquired after February 28, 1913, by bequest, devise, or descent, the fair market price or value of such property on the date of acquisition.

Mr. WALKER. That is exactly the basis under the present law. In the case of any sale of property acquired after February 28, 1913, the gain subject to income tax is the difference between the selling price of such property and the value of such property on the date of acquisition. Subdivision 5 does not change the present treatment at all.

Senator SMOOT. I see it does not change the present basis of imposing the tax as ruled by the department.

Mr. WALKER. It is the present law, Senator.

Senator SMOOT. Do I understand you that if I give away assets that I owned prior to March 1, 1913, the donee is not required to pay any taxes?

Mr. WALKER. At the present time in the case of the sale of the property by the donee he computes his gain as the difference between the price he receives from its sale and the market value on the day he acquires the property by gift.

Senator MCLEAN. I did not understand that was so from your explanation.

Mr. WALKER. Under the proposed bill in order to prevent the evasion of tax on appreciation in the case of sale of property acquired by gift, it is proposed to require the donee to compute the gain on the difference between what he receives from the sale and the cost to the donor. Otherwise stock might be bought for 50, we

will say, in 1915, and appreciated at the present time to 100. The owner could give that stock to some relative for sale. The relative would sell that stock for 102 and the relative would only pay taxes on the $2 gain.

Senator McLEAN. Suppose it is stock owned for more than 6 or 7 years and it is given away and the donee sells it now. How do you estimate the tax on the property?

Mr. WALKER. Under the present law or under this bill?

Senator McLEAN. Under this one.

Mr. WALKER. The difference between what the donee gets and what it cost the donor.

Senator McCUMBER. That would be the case if the donor acquired the property after February 28, 1913.

Mr. WALKER. He said 6 years.

Senator SMOOT. Suppose he owned it 10 or 15 years?

Mr. WALKER. In that case it would be the difference between what the donee gets and the market value on March 1, 1913.

Senator SMOOT. The law does not seem clear to me.

Mr. WALKER. I think the law is clear. Section 202 of the Revenue Act of 1918 provides that for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be:

1. In the case of property acquired before March 1, 1913, the fair market price or value of such property, as of that date;

2. In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.

Senator SMOOT. Yes; that is where the owner sells it.

Mr. WALKER. Yes, sir.

Senator SMOOT. Take it where he gives it away. As I understand you, the tax was not imposed at all.

Mr. WALKER. That is right.

Senator SMOOT. In the event it had been in the owner's hands for ten years or a longer period, before the 1st of March, 1913? Now, it seems to me there should be no distinction in the application of the law in the case of stock that is given away.

Mr. WALKER. That is what we are trying to do in this bill.

Senator McCUMBER. I think the only trouble in this matter is this: Where a man transfers property that has grown considerably in value to a member of his family for the ostensible purpose of having him sell it, and therefore escape any taxes, we ought to have some means to tax them, and I know that it is extremely hard to prove it was not done in good faith. But, on the other hand, suppose you give the property in good faith to a member of your family, and now the member of your family finds he is in such circumstances that he is required to sell it. He received it not for the purpose of avoiding the tax, but he finds out afterwards that his financial situation is such that he ought to sell it. Should we impose that back tax on him? Could we not have some way to protect him against it?

Senator SMOOT. Every time a child of mine is married I give them so much money.

Senator McCUMBER. That is money, and you have paid your tax on that.

Senator SMOOT. Or stock; I give them stock. We intend they shall have an income of so much a month. Now three out of the four have sold every particle of that stock. They said they had to.

Mr. WALKER. The department would not be here asking for this amendment if it did not feel there was much tax evasion under the present law.

Senator MCCUMBER. I admit there is, and the only question is whether we can protect those gifts that are made in good faith and differentiate those made in bad faith, but probably 99 per cent are made in bad faith.

Mr. WALKER. If we could prove they were not made in good faith we could do that under the present law.

Senator MCCUMBER. But not under this proposition. You hold them whether it is made in good faith or not.

Mr. WALKER. Yes, sir.

Senator MCCUMBER. They have to pay that tax if they sell.

Senator NUGENT. I understood you to say that, judging from the experience that you had, the department is thoroughly convinced that there is much evasion.

Mr. WALKER. Yes, sir.

Senator NUGENT. In the payment of taxes?

Mr. WALKER. Of evading the tax in this manner; yes, sir.

Senator NUGENT. Briefly, what has been that experience?

Mr. WALKER. Individuals of high standing advise the Treasury Department frequently that it is their opinion that many persons are adopting that method to evade the tax, and of course it is a very difficult matter to prove that such transactions were wash transactions and not bona fide.

Senator SMOOT. Take a case like this: Suppose I had a farm which I had owned for several years and I decided to give it to one of my boys. I deed it to him, and he in turn decided he was going to move away from the farm and go to another city, and he sold this farm with a view of buying another farm somewhere else or investing in stock, because he decided he did not want to farm any longer; how would he ever get his money to pay the taxes imposed if it were a farm trade?

Mr. WALKER. He would be in the same position as any other person exchanging real estate. Whenever property is exchanged for property a person has to determine what the market value was at the time of sale and at the date of acquisition or on March 1, 1913, if acquired prior thereto.

Senator SMOOT. In other words, if it increases 75 per cent, the boy would have to pay taxes on 75 per cent increase?

Mr. WALKER. Yes, sir.

Senator THOMAS. Wherever there is a gain, there is generally a loss. In the case of the one who sustained a loss would he have to pay the tax?

Mr. WALKER. No, sir.

Senator THOMAS. Suppose there are two gifts—my son and Senator Curtis's son receive a gift.

Mr. WALKER. In the case of an exchange of property, you have to determine in each case the market value at the time of the ex-

change and also the market value on March 1, 1913, or the date of acquisition.

Senator THOMAS. Let us say Senator Smoot and I give to our sons on their wedding day real property worth $3,000, which each of us had owned prior to March 1, 1913; now, they exchange evenly on the first day of March, 1918; and the two properties then were worth, say, $10,000. Would both of them have to pay the tax?

Mr. WALKER. Yes; on $7,000.

Senator NUGENT. Has such a case ever been brought to your attention?

Mr. WALKER. No, sir.

Senator MCCUMBER. Why should they not be taxed, Senator Thomas? Both of them have acquired property or they have sold or traded their property and have made money.

Senator THOMAS. No; they don't make a cent. One of them traded $10,000 worth of property for other property worth $10,000.

Senator MCCUMBER. Not at that time; they have not made it; neither has a person made a cent who has property worth $10,000 and sells it for $10,000, because the books just balance. A trade is just the same as a sale.

Senator SMOOT. There were two brothers given farms by the father, one given a farm in one county and one in another county, and they were equal in value. Now the properties are about equal to-day, but the increases have been great upon all farm lands, and I do know that they have exchanged places, and each one of these boys received the property from their father and would have to pay a tax on the increased value.

Mr. WALKER. That is all taken care of in subdivision (b) of section 202 of the Revenue Act of 1918, which reads:

(b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any.

Senator MCCUMBER. Mr. Walker, I want to give another case and see how the law would work out. Suppose that I buy a piece of property after March 1, 1913, for $10,000. Now, each year I have been adding buildings to that property until that property has actually cost me by such additions, an additional $10,000. I then give it to a member of my family and that member of the family sells it for $20,000, after the gift has been made, for just exactly what it has actually cost me. Under your bill that member would have to pay a tax on the gain of $10,000, would he not, notwithstanding the fact that there was not a cent made on it?

Mr. WALKER. If you keep your books to show you had actually put on buildings costing $10,000 you would be entitled to add in that amount.

Senator MCCUMBER. I don't think the way it is worded that they could give it that construction. I think he would have to hold to the wording of the law and he would have to pay on the difference between the selling price and the original cost, even though I have put into it every dollar for which it was sold.

Mr. WALKER. The term "cost" has been held to mean adjusted cost. Where subsequent improvements have been made through the erection of buildings and the books show it, a taxpayer is entitled to

add the cost of the subsequent improvement to the original cost and to deduct that sum from the selling price in determining the net income subject to tax.

Senator McCUMBER. Are you certain of that?

Mr. WALKER. Yes, sir.

Senator McLEAN. They would have to do that.

Senator McCUMBER. Suppose I pay the difference out in taxes and suppose I have property that costs me $5,000 after March 1, 1913, and I have paid out $5,000 in taxes. That is $10,000; and it is sold then for $10,000.

Mr. WALKER. That would not change the basis at all. You would not be entitled to add that amount, but where you have actually increased the value by the addition of buildings, the additional cost would be added to the original cost.

Senator McCUMBER. I don't think either class of these additions would be permitted.

Senator NUGENT. How long have you been connected with the Internal Revenue Bureau?

Mr. WALKER. I was assistant clerk to the Ways and Means Committee about four years; clerk of the Ways and Means Committee four years; and have been with the Internal Revenue Bureau since March, 1919.

Senator SMOOT. Section 2 amends section 202 of the revenue act of 1918 by adding the following subdivision:

In the case of stock dividends paid after February 28, 1913, the cost to the taxpayer of each share of old and new stock shall be the cost of the old shares of stock [or the market price or value thereof as of Mar. 1, 1913, if acquired prior thereto] divided by the total number of old and new shares of stock: *Provided*, That in cases in which the old and new shares of stock differ materially in character or preference, the cost of the old shares of stock [or the market price or value thereof as of Mar. 1, 1913, if acquired prior thereto] shall be apportioned between the old and new shares of stock as nearly as may be in proportion to the respective values of each at the time the new shares of stock were acquired.

Mr. WALKER. In the first place, this subdivision is the present Treasury regulation.

Senator SMOOT. This is new altogether.

Mr. WALKER. Absolutely, and it is for this purpose. Wherever you get a stock dividend it is necessary to arrive at a basis for computing the gain in the case of a sale of that stock or the stock that was held, with respect to which that dividend was declared. This rules operates as follows: Suppose you hold ten shares of stock in a corporation which cost you a hundred dollars a share and you receive a stock dividend from that corporation of ten shares. Now, suppose you are going to sell your shares with respect to which that dividend is declared or the shares you received as the stock dividend. When you sell those you have to have some basis to determine your gain for income tax purposes. The Treasury has adopted the rule of pooling the stock so held. That is, whether you sell the shares with respect to which you got the stock dividend or your stock dividend shares, that you shall take your cost of the original ten shares or a thousand dollars, and divide that by the number of old shares plus the new shares you got for the stock dividend to get your basic cost.

Senator THOMAS. Is that fair if I have a certain number of shares that cost me a hundred dollars a share and sell them for $200 a share?

Mr. WALKER. The Supreme Court says that you have realized no gain when you receive a stock divend.

Senator THOMAS. I know they do, but they say a great many things that are not true. Now, I get my 10 shares because I am an old stockholder, but it does not cost me anything. We know that. Now, I sell my original 10 shares for $200 a share.

Senator SMOOT. The only trouble is you can not sell that original stock for $200, if it was only worth $100 a share, with a hundred dollar reserve. For instance, take the Deseret Savings Bank of Salt Lake City; their hundred dollar stock is worth $1,000. They issued a stock dividend making 5 shares for every share that they held. The stock then was dropped to $200 a share. It is just as natural as life. That is all there is to a stock dividend. There is not a cent back of the stock more than there was before.

Senator THOMAS. If I am the holder of 10 shares of stock and in consequence of it I get 10 more for which I do not pay a cent, and I afterwards sell all 10 of those shares of stock, no matter what I sell them for, it is all gain to me.

Senator SMOOT. Sure, but if you sold your stock before the dividend was declared, you would get the $2,000 just the same.

Senator SUTHERLAND. That is true of a bank where the assets are intact and tangible, but not always true of all corporations when the stock is based largely on what they can sell it for. Take United States Steel. The book value is way up but the market value is down to 93.

Senator SMOOT. So with the banks. Bank stock is sold upon the rate of interest they pay.

Senator MCCUMBER. I can not see any other way of arriving at the value than has been given.

Senator SMOOT. But the Supreme Court is right where they say there was not a single solitary cent more reserve back of any corporation after declaring a stock dividend than there was before. That is absolutely true.

Senator THOMAS. That may be true. Take an oil company; if I am an owner, say, of 100 shares in a company and they issue stock dividend and I get 50 shares because I am the owner of a hundred shares of stock. To-morrow they open up a new oil field. The stock goes to moving, and anyway there is some outside circumstance which very seriously and very largely increases the value of that stock; I sell it, I sell out; I keep my old stock. Now if that is not clear gain, I am away off.

Senator SMOOT. This is the fact in the case. No one buys stock unless they know the number of shares of the stock that there is in the company, and it is based upon the number of shares of company stock. If they double that stock, it is all upon the same basis, although they bring up the amount.

Senator MCCUMBER. In other words, every share is worth the same.

Senator THOMAS. Of course.

Senator MCCUMBER. The fact is, nevertheless, it seems to me, where stock is doubled, of course it is worth just half as much in reality.

Senator THOMAS. That may be the general rule.

Senator McCUMBER. That is, it is worth just half as much as one-half the stock was before, or the whole stock was before.

Senator SMOOT. Section 3 adds a new section, 207, to the Revenue Act of 1918 which provides in part as follows:

> That compensation received in any taxable year beginning after December 31, 1919, for personal service rendered by the taxpayer during a period of more than three years, and gain derived in any such year from the sale of capital assets acquired more than three years prior to the date of sale, shall be deemed to be extraordinary income; and such income, less losses of the same class or description and the expenses or other deductions properly chargeable thereto, shall be deemed to be extraordinary net income.

That applies to compensation for personal services.

Mr. WALKER. Yes, sir; and to the sale of capital assets which the taxpayer has held more than three years. It applies to real estate, farms or any other property that has been held for more than three years. If you will notice, page 3, line 11, "and gain derived in any such year from the sale of capital assets acquired more than three years prior to the date of sale, shall be deemed to be extraordinary income."

The Treasury Department contemplates having a separate schedule in the income-tax return which will provide for the allocation of such gain pro rata to the years over which such gains have been accruing, and the recomputing of the income tax for those years. The taxpayer will not have to take advantage of this section unless he sees fit to do so, but as it is, numerous sales of real estate are being held up because of the fact that when the sale is made the entire gain during the entire period over which the property has appreciated is held under the law to be income in the year received, which greatly pyramids the income. In many cases the taxpayer after paying the taxes would not receive as much as he could have received for his property before the war period. It is the opinion of the Treasury Department that the present provision of the law treating the income in this way works a great hardship upon the taxpayer, and that the provision suggested in this section will greatly expedite the sales of real estate.

Senator SMOOT. If I bought a piece of real estate three years ago or if I owned a piece of real estate three years ago and sold it on the 25th day of December of last year, you would not tax it for the taxable year of 1917 unless I wanted you to, but I could have the right of having the profits distributed the three prior years?

Mr. WALKER. Not in that case, because the bill is now limited to gains received after December 31, 1919.

Senator SMOOT. It will be hereafter.

Mr. WALKER. Hereafter you can allocate it. If your income from such a transaction is in excess of 20 per cent of your gross income, you can have your income from such transaction allocated to the years over which you held the property.

Senator SMOOT. I don't see much use of that in the future, because the year in which the sale will be made from now on will not be a higher tax than the present. Of course, where the taxes were ascending, it would be.

Mr. WALKER. Your surtax rates are pretty high. They reach 52 per cent at $100,000.

Senator SMOOT. I know they are, but I say they are not going to be any higher.

Senator THOMAS. Can you guarantee this?

Senator SMOOT. Oh, yes; they will raise taxes from some other source.

Senator THOMAS. Suppose I have a client who gives me an annual retainer of $1,500 a year for three years. Is that extraordinary?

Mr. WALKER. No, sir; this provision only relates to gains received during the taxable year for services rendered over a period of more than three years.

Senator SUTHERLAND. This would apply, Senator Thomas, where you may have had a big case pending for 10 years and perhaps drew down $25,000 at the end of that time, yet your services have extended over a period of 10 years, yet your fee came in at one time.

Senator SMOOT. It is to relieve you from paying the higher rate of taxation.

Mr. WALKER. It has considerable equity as well.

Senator MCCUMBER. How would it work out? Suppose the Senator had been working three years on a case in which he got $75,000 in 1920. How would you distribute that?

Mr. WALKER. If he got $75,000 for a three-year period he would add $25,000 to his net income for each of those three prior years, and recompute his tax on a separate schedule on the tax return and pay his additional taxes for those three years at the time he made his return for the year in which he received the fee.

Senator MCCUMBER. Then he would have to pay a surtax and the ordinary tax for the previous three years?

Mr. WALKER. Yes, sir; that additional amount.

Senator MCCUMBER. And he would have the right therefore to treat it as coming in as a lump sum, or go over and have a revision of his taxes for the previous two years and pay on that basis?

Mr. WALKER. It is contemplated having a separate schedule in the income-tax forms so that he can make all the computations on that form.

Senator THOMAS. This begins January 1, 1920.

Mr. WALKER. Yes, sir.

Under paragraph (*d*) of section 250 of the revenue act of 1918, except in the case of false or fraudulent returns with intent to evade the tax, the Treasury Department must make the assessment for income tax purposes within five years after the return was made, and also the taxpayer is limited in bringing suit to a like period of five years. It has been held that that provision only relates to cases arising under the revenue act of 1918. All this subdivision proposes, with the exception of the four classes of cases mentioned therein, is that hereafter the Treasury Department must make the assessment under any and all of the internal revenue acts within five years, and the taxpayer is also barred from bringing suit under any such act unless he brings it within five years after the date when the return was made. The cases exempted are (1) the cases of false or fraudulent returns which are exempted under the present provision; (2) cases in which the tax is determined with the consent of the commissioner and the taxpayer. The third exception to this rule is the case of extraordinary income computed under the provisions of section 3 of this bill,

and amortization claims which arise under sections 214 and 234 of the revenue act of 1918, in which the commissioner has three years after the termination of the present war to arrive at a definite determination of what the final amortization allowance must be. The fourth exception is cases in which the settlement of losses and deductions are only tentatively allowed pending a determination of the exact amount deductible. In other words, the principal feature of this provision is to specifically provide that, except in the cases specified, all the tax cases are going to be definitely closed under all the internal revenue acts within five years.

Section 5 provides for an addition of a new section to the revenue act of 1918. This is believed to be one of the most important sections of this bill from the standpoint of the Treasury and the taxpayer, with reference to expediting the settlement of internal revenue cases.

Senator SMOOT. Let me read it. This is the new part that I will read.

SEC. 1321. That if after a determination and assessment in any case the taxpayer has without protest paid in whole any tax or penalty, or accepted any abatement, credit, or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the commissioner, with the approval of the Secretary, that such determination and assessment shall be final and conclusive, then (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States, and (2) no suit, action, or proceeding to annul, modify or set aside such determination or assessment shall be entertained by any court of the United States.

SEC. 1322. That in case a regulation or Treasury decision made by the commissioner or the Secretary, or by the commissioner with the approval of the Secretary, is reversed by a subsequent regulation or Treasury decision, and such reversal is not immediately occasioned or required by an opinion of the Attorney General or a decision of a court of competent jurisdiction, such subsequent regulation or Treasury decision may, in the discretion of the commissioner, with the approval of the Secretary, be applied without retroactive effect.

Mr. WALKER. May I take up section 1321 first?

The Secretary of the Treasury, in his letter of March 17, 1920, to the chairman of the Committee on Ways and Means, makes the following comment upon this recommendation:

I recommend, therefore, as the most urgent and important of the measures of simplification which could advantageously be put into effect at once an amendment authorizing the Commissioner of Internal Revenue, with the consent of the taxpayer and the approval of the Secretary of the Treasury (or under such other public safeguards as the Congress may prefer), to make a final determination and settlement of any tax claim or assessment, which shall not thereafter be reopened by the Government or modified or set aside by any officer, employee, or court of the United States, except upon a showing of fraud, malfeasance, or misrepresentation of fact materially affecting the determination thus made.

This recommendation is of major importance. At present the taxpayer never knows when he is through. Every time an old ruling is changed by court decision, opinion of the Attorney General, or reconsideration by the department the department feels bound to apply the new ruling to past transactions. The necessity of constantly correcting old returns and settlements is as distressing to the department as it is obnoxious to the taxpayer. But an even more serious situation arises in connection with the assessment of back taxes. The tax return of a large corporation is likely to be crowded with debatable points which the corporation, in the first instance, usually decides in its own favor. The

auditing of these returns has been necessarily delayed by the inability of the Bureau of Internal Revenue to engage and hold a sufficient force of experts to audit promptly the more complex and difficult returns, but when the audit comes to be made it ordinarily brings to light a large amount of back taxes. A prompt determination and collection of such back taxes due would probably bring in additional revenue exceeding $1,000,000,000. On the other hand, this situation must fill the taxpayers concerned with the gravest apprehension. If present taxes be continued and a period of industrial depression ensues during which the department finds time and the men with which to clear up both current and back taxes, within the same year, the result may be highly disastrous to business.

The commissioner should be empowered and directed to dispose of these cases promptly and finally. This procedure would bring in much additional revenue, relieve business from grave uncertainty, keep out of the courts many debatable cases, and help to avert an administrative deadlock.

This section authorizes the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury and with the consent of the taxpayer, to make a final determination and settlement of any tax claim or assessment, which shall not thereafter be reopened by the Government or modified or set aside by any officer, employee, agent, or court of the United States, except on a showing of fraud, malfeasance, or misrepresentation of fact materially affecting the determination thus made.

Here is the proposition: Your large tax cases have often as many as 20 doubtful points for which there is no precedent, and which may be eventually decided one way or another. Now, the accountant and the deputy commissioner in charge of this work who act upon this particular case may finally rule, after consulting with the solicitor, that 19 of those points have to be decided against the taxpayer. Now the following year, in auditing the return for the next year and in comparing the return of the prior year, some other accountant or solicitor or the courts may determine, may decide that the twentieth point was decided incorrectly. Then there is nothing for the commissioner to do but to go ahead and readjust that earlier determination.

Senator THOMAS. Now, under section 1322, suppose this sort of a case comes up: Senator McLean has an application before the department for a refund of $10,000 which he contends he is entitled to under the statute and it is decided against him. I will afterwards have identically the same proposition and you make a decision in my favor. This provides that Senator McLean can not take advantage of that new decision and secure further consideration of his claim.

Mr. WALKER. Yes; that would be the case under 1322.

Senator THOMAS. That seems hardly just.

Senator SMOOT. It simply means we are delegating to the commissioner the power to change the law by regulations of the department.

Senator THOMAS. They decide these cases anyway. The only question in my mind is whether a regulation or changes in the department should not have a retroactive effect. Section 1321 seems to be all right.

Mr. WALKER. As it is at the present time, whenever the Treasury reverses an interpretative ruling it feels that under the present law, it must go back and reopen all prior cases.

Senator THOMAS. You want to avoid this by this section 1322.

Mr. WALKER. In the case of a decision made by the Attorney General or the courts, the Treasury Department would have to reopen all cases involving the same point. This section relates only

to interpretative rulings made by the Commission or Secretary and not occasioned by an opinion of the Attorney General or a court.

Senator McCUMBER. It has more advantages to the taxpayer than to the Government.

Mr. WALKER. There are some very hard cases that arise in the case of interpretative rulings that are reversed. For instance, I have in mind a case of a piano concern. It was a rule that in the case of articles subject to the manufacturers' tax under section 900 of the Revenue Act of 1918, sold to States or municipalities, that the sale was not subject to tax. That ruling was published. At a later date the Attorney General had reason to consider that ruling and reversed the ruling and held all sales under section 900 to States and municipalities were subject to the tax. There is a provision in section 1319 of the Revenue Act of 1918 which provides that if a taxpayer passes on to a purchaser an item as a tax which is in effect not a tax, he is liable to penalty. This concern had been making those sales, tax exempt, and under the decision of the Attorney General that was reversed the musical company which had not passed the tax on, eventually had to pay the tax on all those sales. While this case would not be covered by section 1322, it is believed that there are many cases of severe hardship which could be avoided if interpretative regulations could be made without retroactive effect.

Senator SMOOT. You can get along without section 1322 very well.

Mr. WALKER. We would not insist on that if you think that it is unwise to authorize such a delegation of power. However, I do not think it would be abused and I think it would be very helpful in satisfactorily administering the law.

Senator SUTHERLAND. In the change of administration there might be a different view taken in many cases which might reopen a great number of these cases.

Senator McCUMBER. It seems to me the case is about as broad as it is long. That is, that it is as much a benefit to the taxpayer as to the Government, and I think a little more beneficial to the taxpayer.

Senator SMOOT. I don't like this kind of legislation, though.

Senator McCUMBER. I can give you one case that has been before the department. There was an individual running a sort of a dance hall or dancing place, and his system was to allow people to come in and pay 10 cents or whatever it was and have a seat. Then if they wanted to dance they could go inside the rail and pay ten cents or whatever it was and dance. He presented the matter to the commissioner and asked as to whether or not he should collect a tax from people paying the entrance fee in the first instance, and the commissioner decided that he ought not to collect a tax from them on that entrance for merely the privilege of coming in and sitting down, but he should collect the tax from those who went into the actual place of amusement and took part in the dancing. Thereafter he allowed thousands to come in and look on the dancing and have the benefit of his chairs. After this the department changed this ruling and demanded from him a payment for the tax on all the tickets that had been sold for the entrance in the first instance. I think it was settled afterwards by a sort of a compromise

or backing down on the part of the department, but it would have been mighty convenient if he could have had some arrangement whereby if it were a mooted question he could not be called upon afterwards to pay the tax, and that benefit he would get under this provision.

Senator SMOOT. Yes; but the very recital of this case convinces me that this power should not be delegated to the commissioner.

Senator MCCUMBER. You are assuming, of course, that it will be abused.

Senator SMOOT. I don't know when the regulations will be changed and the decisions of the department will be reversed, and I don't think it is right to give this power.

Senator THOMAS. I don't see any objection to 1321.

Senator SMOOT. No; nor do I.

Senator MCLEAN. Suppose a case has been decided and the taxpayer pays a tax and assumes that his case is settled. Shouldn't there be some protection against a reexamination and reversal of the decision?

Mr. WALKER. I think, Senator, that there is so much difficulty in keeping trained employees that it would not be safe to permit the final determination except at the Washington office.

Senator MCLEAN. What limit, if any, is there upon a reexamination of the return of a taxpayer?

Mr. WALKER. It can be reexamined at any time within five years.

Senator MCLEAN. If he had a dispute and paid his taxes they can be reexamined at any time within five years?

Mr. WALKER. Yes, sir. And if the Treasury Department changes a ruling it feels that under the law it is compelled to go back and make readjustments and make the tax assessments in accordance with the subsequent ruling.

Senator SUTHERLAND. It seems to me there should be a shorter time limit.

Senator SMOOT. It was put at five years because it was not thought that the Government could handle the cases that would arise within a shorter period.

Mr. WALKER. It would not be safe with reference to the 1917 returns to have a shorter period on account of the inability to get sufficient qualified employees and assistants to audit the returns in a shorter period.

Senator SUTHERLAND. There should be some time when these matters should be considered closed.

Mr. WALKER. The Treasury Department feels that five years is necessary at the present time.

Senator SUTHERLAND. But they would not necessarily be closed under this delegation of power desired to be given to the Secretary of the Treasury?

Mr. WALKER. Section 4 provides they shall be closed within five years.

Senator SUTHERLAND. Yes; but under the authority requested he might not decide a case in a shorter time.

Mr. WALKER. If the Treasury Department is given this authority, as soon as a case is in shape for final action, it will be acted on. It is desired to facilitate the closing of these cases and it feels that

this provision will greatly help toward that end and will produce great satisfaction in the handling of the cases from the standpoint of the Treasury Department and the taxpayer.

Senator SUTHERLAND. A great many now are being called upon to pay back taxes and are called upon to pay large sums when probably they have the assistance of Treasury experts and others to make out their returns. And now they are called upon to pay taxes, and there should be some time set in which a man could consider the thing closed.

Mr. WALKER. The Treasury Department is very anxious that at an early date a shorter time limit for the closing of cases may be provided, but with the present volume of work and the difficulty in keeping qualified men it can not adequately protect the revenues and recommend a shorter time limit.

Senator SUTHERLAND. I have heard of numerous cases where people took the expert advice of Treasury experts, and then had to pay large sums in additional taxes.

Senator MCCUMBER. I wish you would give a short explanation of the Liberty Bond exemption.

Mr. WALKER. Section 6 is intended to simplify the Liberty Bond exemption and to give substantially no greater exemption to Liberty Bond holders. Now, the exemptions to Liberty Bond holders are conditioned upon the amount of bonds that they hold under prior acts. If they hold the aggregate amount of bonds permitted to be held tax exempt under the various provisions of the Liberty Bond acts the aggregate exemption for two years after the proclamation of peace, is $125,000, and $50,000 for five years after the proclamation of peace. This provision gives the bond holders a slightly larger exemption than they get under existing law in that it will permit them to hold tax exempt for two years after the proclamation of peace, $125,000, and for five years after such proclamation $50,000 of the 4 per cent and of the 4¼ per cent bonds, without any condition as to whether they hold the proper amount under the prior acts. It is believed it will not cause very much of a reduction in the tax receipts and it will tend to create a slightly better market condition. The main purpose is to simplify the making out of tax returns of the income from Liberty Bonds.

Senator MCCUMBER. Don't you go further than merely simplifying it? Don't you change the law and give them additional exemption or exemptions that they would not be entitled to under the law creating the issues or providing for the issues?

Mr. WALKER. Yes, sir, In case they do not hold the proper amount of bonds required under the various laws to entitle them to the aggregate exemption, but this provision does not give them a larger exemption than they would have if they held the proper amount of bonds required under the various acts.

Senator MCCUMBER. That gives them a benefit over what they would receive, so that all who have bought these bonds with the requirements under existing law that tend to lower their value will have the benefit by an act of law which will create a greater value for those bonds and which will give them the benefit of it in the sale of those bonds.

Mr. WALKER. That is true.

Senator McCUMBER. That does not seem to me hardly to be in accord with justice.

Mr. WALKER. It is a great step in the interest of simplification of the tax return, and it is not believed that it will materially reduce the revenue.

Senator SMOOT. It will reduce the revenue or there is no use to pass the law.

Mr. WALKER. It will, slightly. There is no doubt about that.

Senator SMOOT. The only thing I can see in it, is that it may create an improved market for the 4 and 4¼ bonds, and perhaps increases the value of those bonds. There will be a greater demand for them.

Senator McLEAN. The only purpose I can see is this, that those securities were sold by those people who could not afford to hold them. They were bought then at this depreciated value. Then we passed a law which enabled the present holders to sell them at an appreciated value. That does not appeal very strongly to me.

Senator SMOOT. Whatever appreciation is made, they obtain.

Senator SUTHERLAND. Why not make the date a fixed date rather than at the time of the proclamation of the President or by act of Congress?

Mr. WALKER. That is part of the contract on your bond. I was talking to Mr. Gilbert, assistant to Mr. Leffingwell, this morning and he is very much worried about the amendment put in the bond provision on the floor of the House. It inserts the words "by Congress or". It is his opinion that that amendment materially changes the contract in the bond. The bond carries the provision that the exemption period shall be determined by the proclamation of the President.

Senator SUTHERLAND. Nobody would complain if conditions were improved.

Mr. WALKER. The House amendment possibly might not improve it. It might shorten the exemption period. Secretary Leffingwell thinks those words should be eliminated. That is on page 7, line 14; strike out "by Congress or".

Senator SMOOT. You say that is on page 7, line 14?

Mr. WALKER. Line 14, "by Congress or".

Senator McCUMBER. Have you anything further to say, Mr. Walker?

Mr. WALKER. With reference to H. R. 14198, in order to make certain the date of effectiveness of section 1 of the act, may I suggest the following amendments:

On page 2, line 1, strike out the word "In" and insert "After December 31, 1919."

On page 2, line 5, strike out the word "In" and insert "After December 31, 1919."

On page 2, line 6, after the word "Gift," insert "Since February 28, 1913."

Mr. WALKER. In the case of sale or exchange of property acquired by gift, we want to make it clear that it relates to gifts made after ratification of the income tax amendment to the Constitution.

Senator SMOOT. Is that not assumed?

Mr. WALKER. Probably; but that makes it clear.

On page 3, line 12, after the word "sale," add the words "or exchange."

Now, if you will turn to H. R. 14197, on page 3, line 16. On page 3, line 16, after the first word, "the," insert the word "last."

Here is a new section that the Treasury Department would like you to consider in the personal service corporation provision bill, H. R. 14197.

On page 4, after line 11, insert a new section to read as follows:[1]

SEC. —. That section 220 of the Revenue Act of 1918 is amended to read as follows:

"That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, such corporation shall not be subject to the tax imposed by section 230, but the stockholders or members thereof shall be subject to taxation under this title in the same manner ~~as provided in subdivision (a) of section 218 in the case of stockholders of a personal service corporation,~~ *as the members of partnerships, and all the provisions of this Title relating to partnerships and the members thereof so far as practicable shall apply to such corporation and the stockholders thereof: Provided, That for the purpose of this section amounts distributed by such a corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares,* except that the ~~tax~~ *taxes* imposed by Title III *of this Act, or sections 9 and 10 of the Personal Service Corporation Act* shall be deducted from the net income of the corporation before the computation of the proportionate share of each stockholder or member. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each."

Now, if you eliminate your reference to personal service corporations in the revenue act of 1918, section 220 of such act will no longer have any effect, and therefore in case of close corporations, if the corporation should decide to keep its income in the corporation so the members would not be liable to the surtax, we would have no way to compel them to make this distribution.

If this amendment is adopted a new section should be inserted in the bill as follows:

SEC. 13. That this Act may be cited as the "Personal Service Corporation Act."

On page 6, line 22, the figure "11" should be stricken out and the figure "12" substituted.

Now, there is one question of policy that has been called to the attention of the bureau since this bill was reported by the House which I think should be called to your attention.

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[1] The part printed in Roman indicates the present law, the part stricken through shows the matter proposed to be stricken out; and the part in italics indicates the new matter proposed to be inserted.

Mr. WALKER. This question arises in the case of the sale of property acquired by gift. In such case the basis for determining gain or loss under the proposed bill is the cost to the donor, and that donor possibly has held the property a year and the donee sells it after having held it a little more than two years. In such cases, it has been suggested that it should be provided that the period the donor held the property can be linked up with the period the donee held it, and if the donor and the donee held it for more than the three year period that the donee should be given the privilege of apportioning the gain over the period that the property was held by the donor and donee. There is some equity in that.

Senator SMOOT. I suppose there would be the same equity in this as there would be in the other case?

Mr. WALKER. Thank you very much.

(Thereupon the committee adjourned.)