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INTERNAL REVENUE CODE PROVISIONS RELATING TO POSSESSIONS

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

REPORT

together with

MINORITY VIEWS

[To accompany H.R. 5547]

The Committee on Finance, to whom was referred the bill (H.R. 5547) to amend certain provisions of the Internal Revenue Code of 1954 relating to possessions of the United States, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. SUMMARY OF BILL

The House bill deals with two basic subjects. The first of these imposed limits on the extent to which income tax liability incurred in the Virgin Islands can be reduced by grants, subsidies or similar payments. The second subject provided that the U.S. estate and gift taxes were to apply to residents of U.S. possessions who are also citizens of the United States only by reason of citizenship in the possession in the same manner as "nonresidents who are not citizens of the United States." With relatively minor amendments, your committee has accepted these provisions of the House bill. In addition, it has added to the bill the following amendments relating to other matters:

1. Section 6 of the bill treats capital contributions to the Federal National Mortgage Association, to the extent they exceed the value of the stock on the issue date, as ordinary and necessary business expenses to the initial holder of the stock (a corresponding reduction in the basis of the stock is also provided for).

2. Section 7 of the bill, under certain conditions, provides a charitable contribution deduction (not over $50 a month) for high school or elementary school students maintained in the taxpayer's home

under the sponsorship of a charitable organization, veterans' organization, or fraternal society.

3. Section 8 of the bill provides that expenditures by farmers for fertilizer, lime, limestone, or marle can be expensed rather than treated as capital items and written off over a period of more than a year.

4. Section 9 of the bill is designed to prevent a doubling up of deductions for State taxes in the case of accrual basis taxpayers where the doubling up is a result of the action of a taxing jurisdiction taken after December 31, 1960.

5. Section 10 of the bill provides that certain pension trusts established under collective-bargaining agreements are to be considered as qualified trusts from the date they were established.

6. Section 11 of the bill amends the business lease provision of the code to provide a new exception in the case of a lease by a medical research organization to a medical clinic of adjacent premises. Thus, rent received by a medical research organization under these circumstances will be exempt from the unrelated business income tax.

7. Section 12 of the bill provides that stock owned by a trust or estate, for purposes of determining whether a corporation is a personal holding company, will be treated as being owned by the beneficiaries of the trust or estate in proportion to their actuarial interest in the trust or estate.

8. Section 13 of the bill would add new sections 1111 and 1112 to the Internal Revenue Code of 1954 to provide special tax treatment for shareholders to whom stock is distributed pursuant to an order enforcing the antitrust laws.

9. Section 14 of the bill provides that the ratio for determining the limitation on the amount of the gift tax to be allowed as a credit against the estate tax is to be determined on the basis of the taxable estate (with adjustments) rather than on the basis of the gross estate. This section also provides that where gifts are included in the gross estate for estate tax purposes, any gift tax paid on gifts made after the date of enactment of this act also is to be included in the estate tax base and the limitation on the gift tax credit is to be inoperative with respect to these gifts.

10. Section 15 of the bill imposes import taxes on lead and zinc.

11. Section 16 of the bill permits foreign embassies and legations to withdraw from a customs-bonded warehouse for consumption in the United States certain distilled spirits and wine which have been bottled in bond for export or which have been labeled for export.

II. LIMITATION IN REDUCTION OF INCOME TAX LIABILITY INCURRED TO THE VIRGIN ISLANDS (SEC. 1 AND PART OF SEC. 5)

For many years (since the Naval Appropriations Act of 1921) the income tax laws of the United States have been applicable to the Virgin Islands as if these laws had been separately enacted for the Virgin Islands, substituting the name "Virgin Islands" for references to the United States in the income tax laws. The effect of this dual tax system, or "mirror system" as it has sometimes been called, has been to require persons incurring liability to both the United States and the Virgin Islands to report and pay tax to both. However, double taxation was prevented through the allowance by the United States of a foreign tax credit with respect to income derived from sources within the Virgin Islands, and by the application by the Virgin Islands of a foreign tax credit with respect to income derived from sources within the United States.

The Revised Organic Act for the Virgin Islands of the United States, passed in 1954 (Public Law 517, 83d Cong., 2d sess., S. 3378), however, made substantial changes in this tax treatment. This act provided:

> That the term "inhabitants of the Virgin Islands" as used in this section (section 28a) shall include all persons whose permanent residence is in the Virgin Islands, and such persons shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources both within and without the Virgin Islands into the Treasury of the Virgin Islands.

The effect of this change was to require inhabitants of the Virgin Islands, namely permanent residents of those islands, to pay their entire income taxes to the Virgin Islands, even though part of their income was derived from sources within the United States. As a result, the tax on the income of permanent residents of the islands from sources within the United States now is being covered into the Virgin Islands Treasury rather than into the U.S. Treasury.

This change became particularly significant in view of the passage by the Virgin Islands Legislature, and signing by the Virgin Islands' Governor, of Act No. 224, designed to encourage the establishment of new businesses and industries in the Virgin Island through the granting of special subsidies. Although the Revised Organic Act provided the Virgin Islands no authority to rebate income taxes paid to it, either with respect to income derived from sources within the Virgin Islands or from sources derived in the United States, nevertheless the legislature achieved substantially the same effect in Act No. 224 by providing subsidies ranging from 50 to 75 percent of the income taxes paid by corporations and residents with respect to certain specified types of new investment. These subsidies were granted with respect to the tax attributable both to income from sources within the Virgin Islands and from sources within the United States. Specifically, the income tax subsidies provided by that act were in the following five general categories:

1. Seventy-five percent of the income tax payable for a period of 10 years by persons, firms or corporations qualifying as "new businesses." A "new business" in this case is, in general, defined as one involving manufacture of an article, or the application of a process, which was not being manufactured or applied in the islands prior to January 1, 1947, if the industry has a capital investment of at least $10,000, but only to the extent not in competition with existing enterprises.
2. Seventy-five percent of income taxes payable for a period of from 10 to 16 years by persons, firms or corporations operating hotels and guesthouses in the islands in which there is an investment of at least $100,000.
3. Seventy-five percent of the income taxes payable for a period of 10 years by persons, firms, or corporations constructing or

operating apartment houses, housing projects, or industrial or commercial buildings in the islands in which there is an investment of at least $100,000.

4. Fifty percent of the income taxes paid for a period of 10 years by persons, firms, or corporations on the portion of their income derived from the purchase, transfer, assignment or sale of stocks, bonds and other securities purchased or sold through an investment company located in and authorized to do business in the Virgin Islands. The subsidy granted to any one person under this provision may not exceed $100,000 a year and for more than half of this subsidy to be paid to a taxpayer, one-half of the subsidy must be invested in the Virgin Islands in projects which will further the economic development of the islands.

5. Fifty percent of the income taxes paid on income derived by stockholders or partners from the operation of firms or corporations which qualify for a subsidy in any of the four above categories.

Your committee, while recognizing the desirability of the economic development of the Virgin Islands, agrees with the House that in no case should this be attained by granting windfall gains to taxpayers with respect to income derived from investments in corporations in the continental United States, or with respect to income in any other manner derived from sources outside of the Virgin Islands. In this connection your committee is glad to note that on April 29, 1959, the Virgin Islands government enacted Act No. 395, amending Act No. 224 to eliminate the subsidy program with respect to securities and also designed to limit the subsidy program to income derived from sources outside the United States. Although this in large measure removes the aspects of the Virgin Islands subsidy program with which your committee was most concerned, it doubts the desirability of leaving the opportunity to the Virgin Islands to adopt such a program at any time in the future that it may see fit.

For these reasons both the House and your committee in the first section of this bill, with two specified exceptions noted below, deny the right to the Virgin Islands to make any grant, subsidy, or other payment which has the effect either directly or indirectly of reducing tax liability incurred to the Virgin Islands under the Internal Revenue Code as made applicable to the Virgin Islands by the Naval Appropriations Act of 1921 or by section 28a of the Revised Organic Act of the Virgin Islands (approved in 1954).

The first exception relates to United States or Virgin Islands corporations and, in general, provides that subsidies can be paid to these corporations under much the same conditions as those under which income tax exemptions are presently available in the case of U.S. corporations carrying on a trade or business in most other U.S. possessions (sec. 931 of the code). The second exception relates to citizens of the United States (both those who are citizens by reason of the special act of Congress relating to the possession, and those who are citizens by reason of birth in the continental United States, naturalization, etc.) who are bona fide residents of the Virgin Islands and permits the granting of subsidies in much the same manner as bona fide residents of Puerto Rico may claim an exemption from U.S. income tax with respect to their income derived from sources within Puerto Rico (sec. 933 of the code). In general terms, these exceptions permit the Virgin Islands to provide, through the subsidy program, what amounts to much the same treatment as that already provided by income tax exemption with respect to other possessions in the case of U.S. corporations, or along the lines of the treatment provided residents of Puerto Rico in the case of citizen residents. This appeared to your committee to be in accord with the purpose of the special tax treatment long accorded possessions of the United States, namely, to encourage the development of the economic resources of the possessions by citizens of the United States or by U.S. corporations.

More specifically, the extent to which subsidies may be granted to domestic or Virgin Islands corporations is limited to the portions of their income which these corporations derive from sources without the United States. In addition, two income requirements must be met. First, to be eligible for this treatment 80 percent or more of the corporation's income for the 3-year period preceding the close of the taxable year (or for the applicable part of that period) must have been derived from sources within the Virgin Islands. Second, 50 percent or more of the gross income of the corporation for the same period of time must have been derived from the active conduct of a trade or business within the Virgin Islands. In making these computations all amounts received by these corporations within the United States, whether or not actually derived from sources within or without the United States, are to be considered as being derived from sources within the United States. The effect of this is to deny any subsidy with respect to this portion of the tax payments made by the corporation as well as to treat this income as derived from sources without the Virgin Islands in the case of the 80-percent test.

Both in applying the 80-percent test and the 50-percent test the House bill provided that they were to be computed without the benefit of section 931. Further analysis of the provisions makes it apparent that this exception is unnecessary in view of the fact that the gross income of a corporation which meets the requirements of section 931 is limited to income from sources within the United States. Therefore, your committee has deleted these two exceptions. It has also provided that in applying the foregoing tests gross income of a Virgin Islands corporation, and the sources from which the income of such a corporation is derived, is to be determined as if such a corporation were a domestic corporation. This appears necessary since a Virgin Islands corporation is for other purposes of the United States tax laws treated as a foreign corporation and, therefore, its income from Virgin Islands sources would not otherwise constitute gross income and the 80 percent and 50 percent tests would be ineffective.

The subsidy in the case of individuals is limited to citizens of the United States. This includes those who are citizens of the United States by reason of being a citizen or resident of the Virgin Islands as well as all other citizens of the United States. However, the citizen must also have been a bona fide resident of the Virgin Islands during the entire taxable year in question. One who meets both the citizenship and residence requirements may qualify for a subsidy payment to the extent his income is derived from sources within the Virgin Islands. However, there is one exception to this rule: subsidy payments may not be made with respect to amounts received for services performed as an employee of the United States, or any agency of the United States.

Your committee has modified the House provision limiting subsidies in the case of individuals to provide that gain or loss from the sale of securities is not to be treated as income derived from sources within the Virgin Islands. This is designed to prevent the granting of subsidies for stock in American and other corporations merely on the grounds that the sale of the stock occurs in the Virgin Islands.

For the subsidy payments to be permitted, either in the case of corporations or individuals, information must be supplied to the Secretary of the Treasury or his delegate to the extent that he considers the information necessary in order to determine whether the individual or company receiving the subsidy properly qualifies.

These provisions as amended by your committee are to apply to tax liability for taxable years beginning on or after January 1, 1960.

III. ESTATE AND GIFT TAX TREATMENT OF CERTAIN CITIZEN RESIDENTS OF POSSESSIONS (SECS. 2, 3, 4 AND PART OF 5)

Present law provides that upon the death of a citizen or resident of the United States, an estate tax is to be imposed with respect to all property left by the decedent wherever situated except real property situated outside of the United States. In the case of the death of nonresidents who are not citizens of the United States, present law imposes an estate tax only with respect to property situated in the United States. However, in the case of deaths of residents of U.S. possessions whose citizenship was derived from citizenship in a possession, the courts have held that such residents fell in neither of the two above categories with the result that in these cases the imposition of the estate tax was avoided entirely.

In *Estate of Albert D. Smallwood* (11 T.C. 740; 1948) the Tax Court held that the estate of a citizen of the United States who resided in, and acquired citizenship in, Puerto Rico was not subject to estate tax as a citizen of the United States. Subsequently, in 1955 the Tax Court in *Estate of Arthur S. Fairchild* (24 T.C. 408) held that the estate of a citizen of the United States resident in the Virgin Islands was not subject to the estate tax. In addition, in *Estate of Rivera* (19 T.C. 271, aff'd. 214 F. 2d 60; 2d Cir. 1954) the courts have held that the estate of a citizen of Puerto Rico who was not otherwise a citizen of the United States was not subject to the estate tax as a nonresident decedent not a citizen of the United States.

The results reached in these decisions are based on the theory that the United States does not extend its Federal tax system to possessions unless Congress expressly so provides and the courts have, therefore, held that Congress by not extending the scope of the estate tax had not extended the scope of the estate tax to include citizens of U.S. possessions whether or not they otherwise were U.S. citizens. The Internal Revenue Service not only followed these decisions but also believed that the legal conclusions upon which they were based were equally applicable to the gift tax.

As a result of these decisions, Congress in the Technical Amendments Act of 1958 made the estate and gift taxes specifically applicable in the case of citizens of the United States who are residents of a possession but only if the citizen did not become a citizen of United States solely by being a citizen of a possession or solely by reason of his birth within a possession of the United States or solely by reason of his residence within the possession. (Hereafter those who attained U.S. citizenship solely as a result of one of these factors will for convenience be referred to as being a citizen of a U.S. possession.) With respect to these citizens of United States who are residents of a possession but whose citizenship was not derived from citizenship in a U.S. possession, the estate and gift tax provisions were made applicable in the same manner as is generally true in the case of citizens of the United States. As a result, such citizens who are residents of a possession are subject to U.S. estate tax with respect to all property, real or personal, tangible or intangible wherever situated, except real property situated outside of the United States. Similarly, in the case of the gift tax, such U.S. citizens who are residents of a possession at the time they make a gift are subject to gift tax with respect to all gifts of property which is real or personal, tangible or intangible and without regard to whether the property is situated within or without the United States.

Although making the estate and gift taxes applicable to U.S. citizens who were residents of a possession, if their citizenship arose other than from citizenship of a possession, Congress did not in 1958 deal with the problem of those residents of a possession whose citizenship was derived from the possession. The problem was recognized but it was believed that further time was required for the study of the appropriate tax treatment for these citizens of a U.S. possession.

The House and your committee in this bill recommend that these citizens of a U.S. possession be subject to the estate and gift tax imposed by the United States, in general, to the same extent as in the case of nonresidents not a citizen of the United States.

The effect of this, in the case of the estate tax, is to impose the U.S. estate tax with respect to the portion of the gross estate of these citizens of U.S. possessions who are residents of the possessions at the time of their death, only with respect to that part of their gross estate which at the time of their death is situated in the United States. For this purpose shares of stock held by the decedent are treated as property situated in the United States only if issued by a domestic corporation. On the other hand, property such as proceeds from life insurance and bank deposits, even though physically in the United States at the time of the decedent's death are not considered property situated within the United States unless the decedent was engaged in business in the United States at the time of his death.

The $60,000 estate tax exemption generally available to citizens of United States and to residents of United States is to be available to citizens of U.S. possessions only in the same proportion which their gross estate situated within the United States bears to their total gross estate, except that in no case is the exemption to be less than $2,000. This can be illustrated by a citizen of the Virgin Islands (or Puerto Rico) who died owning bonds valued at $45,000 which were situated in the Virgin Islands (or Puerto Rico) and shares of U.S. corporations valued at $30,000. In this case his gross estate situated in the United States is $30,000 or thirty seventy-fifths of his entire gross estate. As a result, his exemption in this case would be thirty seventy-fifths of $60,000 or $24,000.

In the case of the gift tax, this bill provides that a donor who is a citizen of a U.S. possession, as well as a resident of such a possession, is for purposes of this tax to be treated as a nonresident not a citizen of the United States. This means in the case of the gift tax that one of these citizens and residents of a U.S. possession at the time he makes a gift will be subject to the gift tax if, but only if, the property transferred is situated within the United States. For this purpose stock issued by a corporation is considered property situated within the United States only in the case of domestic corporations, but the making of a gift of stock of a domestic corporation, or any other intangible property with a situs within the United States is subject to the gift tax only if the donor resident of the possession is engaged in business in the United States at any time during the year in which the gift of the stock is made.

The estate tax amendments made by this bill are to be effective with respect to estates of decedents dying after the date of enactment of this bill. The gift tax amendments made by this bill are to be effect tive with respect to gifts made after the date of enactment of this bill.

IV. NONREFUNDABLE CONTRIBUTIONS TO FEDERAL NATIONAL MORTGAGE ASSOCIATION (SEC. 6)

The Federal National Mortgage Association is a mixed-ownership Federal corporation, having on January 1, 1960, preferred stock of $142,820,000 owned by the Federal Government and common stock of $53,319,200 owned by more than 5,800 different private shareholders. The Association was originally chartered by Congress in 1938 and rechartered in 1954. One of its principal purposes is to supplement the general secondary market for home mortgages. As a result, when a financial institution such as a bank or other mortgage lender or investor desires to obtain more liquid funds, it may sell qualifying mortgages to the Federal National Mortgage Association.

The 1954 act rechartering the Association provided, however, that the Association was to accumulate capital funds by requiring each mortgage seller to make payments of specified amounts of nonrefundable capital contributions to the Association in exchange for capital stock of the Association. Currently, the amount to be paid by a taxpayer-subscriber must equal 2 percent of the unpaid principal of the morgages he is selling to the Association and for this the Association issues stock on the first day of the succeeding month.

Problems have arisen as to the tax treatment provided for this stock which must be purchased by a taxpayer when he sells mortgage paper to FNMA. The problems have arisen because, although there is a market for the FNMA stock, the market price is appreciably below the stock issuance price, currently the market price being around 55 percent of the issuance price.

Taxpayer-subscribers generally have assumed that any excess of the issuance price over the market price of this stock represented an ordinary and necessary expense incurred in carrying on their trade or business since they acquired the stock in order to sell their excess supply of mortgage paper. In 1958, however, the Internal Revenue Service ruled (Rev. Rul. 58–41, 1958–1 CB 86) that no part of the purchase price of stock of FNMA constituted a deductible business expense. Instead, it was held that the entire amount paid for the stock must be capitalized and treated as the cost of the stock so acquired. Thus, this ruling holds that there is no tax effect at the time of the purchase or issuance of the stock even though the market price of the stock then is substantially below the issuance price. Instead, the tax effect occurs only when the stock is sold by the taxpayer.

Your committee believes that it is unfortunate to require the capitalization of these expenditures for FNMA stock by taxpayer-subscribers to the extent they represent the excess of purchase price over market price. Viewed from such a taxpayer's standpoint, the excess appears clearly to be expenditures which he must incur in order to sell the mortgage paper he holds. In view of this, your committee believes that such amounts should be treated as ordinary and necessary expenses incurred in carrying on a trade or business. This, of course, means that in the transaction which occurs when the stock is sold (usually a capital transaction) the basis of the stock should not include this amount previously taken as a deduction.

As a result, section 6 of the bill adds a new subsection (d) to the section of existing law relating to the deductions of trade or business expenses (sec. 162). The new provision relates to the purchase of FNMA stock where this stock is purchased in order to sell mortgage paper to the Association. In such cases the bill provides that any excess of the issue price of the stock over its fair market value on the date of issue is to be treated as an ordinary and necessary business expense of that year in carrying on a trade or business. As a result, this excess will be a deduction against ordinary income of the taxpayer for the year the stock is purchased or issued.

Section 6 also provides that the basis of the FNMA stock is to be reduced by the amount required to be deducted against ordinary income under the new provision. As a result, the taxpayer cannot, upon the sale of the stock, receive a tax benefit a second time for the amount previously deducted as an ordinary expense item.

This change is to be effective for taxable years beginning after December 31, 1959. In making this statutory amendment, however, your committee intends no inferences to be drawn as to the tax treatment accorded FNMA stock before the enactment of this provision.

V. CHARITABLE CONTRIBUTIONS FOR CERTAIN STUDENTS MAINTAINED IN TAXPAYER'S HOME (SEC. 7)

A. GENERAL STATEMENT

Under present law, charitable contributions are deductible for Federal income tax purposes only if they are paid to or for the use of an organization described in the statute. Amounts paid to or for the use of any individual do not qualify for deduction, even though they are paid for a charitable purpose.

This provision amends section 170 of the Internal Revenue Code to allow a deduction, as a charitable contribution, of amounts, not averaging more than $50 per month, which are paid by the taxpayer to maintain in his household certain individuals who are not his dependents and who are not related to him. This new deduction will be available with respect to an individual who is a full-time student or pupil in the 12th or any lower grade at an educational institution provided he is a member of the taxpayer's household under a written agreement between the taxpayer and certain charitable organizations, veterans' organizations or fraternal societies described in the Internal Revenue

Code to which contributions are presently deductible for income tax purposes. Under your committee's bill, amounts paid to maintain such an individual in the taxpayer's home are treated as if they had been paid directly to or for the use of the specified charitable, religious or educational organization with which the written agreement is made. However, this new deduction will not be available if the taxpayer receives any money or other property as compensation or reimbursement for maintaining the individual in his household even though such money or property is used for the care of the individual.

Your committee believes that this provision will encourage taxpayers to take into their homes Indian children, and also foreign children whose presence in this country is sponsored by a charitable institution, under a program of the organization designed to provide educational opportunities for pupils or students in private homes. However, this new deduction is not restricted to Indian and foreign children, but is available with respect to any individual, under a program of a charitable institution, who is not related to or dependent upon the taxpayer and who is attending school on a full-time basis in the 12th, or any lower, grade.

This provision shall apply with respect to taxable years beginning after December 31, 1959.

B. TECHNICAL STATEMENT

This section amends section 170 of the Internal Revenue Code of 1954 (relating to charitable, etc., contributions and gifts) by adding a new sentence at the end of subsection (c) which would include in the term "charitable contribution" an amount treated under the new subsection (d) (added by the bill) as paid for the use of certain organizations described in subsection (c). Present subsections (d) and (e) are redesignated as subsections (e) and (f), respectively.

Under present law, a taxpayer is not entitled to a deduction under section 170 for any amounts paid directly to or on behalf of an individual. In general, section 7 of the bill makes such a deduction possible by treating as charitable contributions amounts paid by a taxpayer to maintain a nondependent and unrelated individual while such individual is both a member of the taxpayer's household under an agreement implementing an educational program sponsored by an organization described in paragraph (2), (3), or (4) of subsection (c), and a full-time student at an educational institution described in the bill.

Individuals

Under the bill, the individual with respect to whom maintenance payments are made must not be a dependent, as defined in section 152, or a relative of the taxpayer. The term "relative of the taxpayer" means an individual who, with respect to the taxpayer, bears any of the relationships described in paragraphs (1) through (8) of section 152(a). The individual must also be a full-time pupil or student in the 12th or any lower grade at an educational institution (as defined in sec. 151(e)(4)) located in the United States. The bill further provides that the individual must be a member of the taxpayer's household under a written agreement between the taxpayer and the organization which sponsors the individual.

Certain organizations

The organization which sponsors the individual must meet two requirements. First, it must be an organization described in paragraph (2), (3), or (4) of section 170(c). Secondly, the organization must be engaged in a program to provide educational opportunities for pupils or students placed in private homes by such organization.

Limited deduction

A deduction is not permitted for any taxable year for an amount in excess of $50 multiplied by the number of full calendar months which fall within the taxpayer's taxable year and during which the individual referred to is a member of the taxpayer's household and a full-time pupil or student. For purposes of determining whether an individual is a member of the taxpayer's household and a full-time student for a calendar month, 15 or more days are treated as a full calendar month.

Temporary absences

To be considered a full-time pupil or student an individual must be enrolled in school and be actively attending classes. However, if an individual is temporarily absent from class due to special circumstances, he may be considered a full-time student so long as he is enrolled in school and resumes classroom attendance upon the termination of the special circumstances. For example, if an individual regularly enrolled in school is absent from class for 20 days of a calendar month due to illness, he is nonetheless considered a full-time student for the calendar month, provided that the individual resumes classroom attendance upon recovering from the illness. Similar rules apply in determining whether an individual is a member of the taxpayer's household. That is, a student may be considered a member of the taxpayer's household notwithstanding temporary absences due to special circumstances.

Maintenance

Amounts paid to maintain an individual do not have to be paid pursuant to a written contract with the sponsoring organization in order to be deductible, although the status of the individual as a member of the taxpayer's household must arise under a written contract. Subject to the monetary limitation, a deduction is permitted for any amount paid to ensure the well-being of the individual, and to carry out the purpose for which the individual was placed in the taxpayer's home. Thus, amounts paid for books, tuition, food, clothing, and a reasonable allowance for the entertainment of the individual may be used in determining whether the limitation to an average of $50 a calendar month is reached. However, depreciation sustained on the taxpayer's house is not to be included, since depreciation is not paid by the taxpayer. Also, no deduction is permitted for the value of services rendered to the individual by the taxpayer or members of the taxpayer's household. This is in accord with the denial of a deduction for services generally under section 170.

Compensation or reimbursement

Subsection (a)(2) of this section expressly provides that the taxpayer may not receive money or other property as compensation or reimbursement for maintaining a qualifying individual. This provision is designed to limit the deduction to those cases where a taxpayer enters into a written contract with a sponsoring organization with the intent to relieve the organization of the costs of carrying on a program to provide educational opportunities for pupils or students in private homes. It is not intended, however, to deter a taxpayer from prepaying certain extraordinary or nonrecurring expenses of the organization or of some other person, such as the individual's parents. The following examples will serve to make the operation of this provision clear:

Example 1.—A taxpayer who otherwise qualifies under the bill agrees to maintain a student as a member of his household with the understanding that the sponsoring organization will pay to him $30 a month. The total cost of maintaining the student is $50 a month. The taxpayer is not entitled to a deduction with respect to the difference of $20, since he is receiving monthly compensation from the organization.

Example 2.—A taxpayer who otherwise qualifies under the bill takes a student whom he is maintaining as a member of his household to Florida on vacation during Christmas, which is a holiday celebrated by the school in which the student is enrolled. It is a yearly practice of the taxpayer to take such a trip during the Christmas season, but the student accompanied the taxpayer at the request of the student's parents. The parents reimbursed the taxpayer for the portion of the cost of the trip attributable to the student. No portion of the cost of the trip is deductible under the bill; however, other amounts spent for the student's maintenance would be deductible, since the taxpayer in this case merely prepaid a special, nonschool expense which was properly the obligation of another person.

Example 3.—A taxpayer who otherwise qualifies under the bill requires the student whom he is maintaining as a member of his household to work in the taxpayer's business after school hours and during weekends. The services the student renders to the taxpayer are substantial and the taxpayer would ordinarily pay $15 per week for them. The taxpayer does not pay the student any cash for the services rendered. Nevertheless, the taxpayer is not entitled to a deduction for amounts paid for the maintenance of the student, since the taxpayer has, in effect, received money from the student for maintenance.

No other amount allowed as deduction

Subsection (a)(2) of this section further provides that no deduction shall be allowed for any amount paid to maintain an individual under a program to provide educational opportunities for such individual unless such amount is deemed to be a charitable contribution under the provisions of the bill. This provision denies a deduction for any amount paid in excess of the limit provided in the bill, regardless of some other theory of deductibility. It also denies any deduction under section 170 for amounts paid to maintain an individual under such a program where the program is administered by an organization other than one described in paragraph (2), (3), or (4) of section 170(c).

Subsection (b) of this section amends section 162(b) of the code to prohibit a deduction under section 162(a) for any amount which would be allowable as a deduction under subsection (a) were it not for the dollar limitations set forth therein. Subsection (c) provides that the amendments made by this section of the bill shall apply with respect to taxable years beginning after December 31, 1959.

VI. EXPENDITURES BY FARMERS FOR FERTILIZER, LIME, ETC. (SEC. 8)

For many years it has been the universal practice for farmers to deduct the cost of fertilizer and lime in the year in which it is paid or incurred. Recently, however, cases have been called to the attention of the committee in which the Internal Revenue Service has questioned a deduction for lime and fertilizer on the ground that its cost is a capital expense which should be spread over the beneficial life. This is contrary to the long-accepted and widespread practice of deducting fertilizer and lime expenditures in the year they are paid or incurred.

In order to make certain the intention of Congress that these expenses be treated as business expenses, your committee has added a new section 180 to the Internal Revenue Code which permits a taxpayer to elect to treat expenditures for fertilizer, lime, ground limestone, marle, or other materials used by him to enrich, neutralize, or condition his farmland, or for the application of such materials, as expenses which are not chargeable to capital account. Thus, such expenses, as in the past, may be deductible in full in the year in which they are paid or incurred if the farmer so elects. This new provision is merely declaratory of existing law and makes no substantive change in the application of the statute.

While the amendment made by this section applies to taxable years beginning after December 31, 1959, since it is declaratory of existing law it should be applied to past years as well.

VII. LIMITATION ON ACCELERATION OF ACCRUAL OF STATE TAXES (SEC. 9)

Section 164(a) of the Code allows a deduction for "taxes paid or accrued within the taxable year." Under this language, the accrual basis taxpayer is allowed a deduction in the year the taxes accrue regardless of when they are paid. As a general rule, developed through judicial and administrative interpretations, the date of the event which renders the taxpayer unconditionally liable for the tax is considered the proper accrual date. With respect to personal and real property taxes, the accrual date is generally considered either the assessment date, personal liability date, or the lien date, or a combination of these dates. Section 461(c) of the code allows accrual basis taxpayers, at their election, to accrue real property taxes ratably over the period of time to which they relate. Section 461(c) is limited to real property taxes and few taxpayers have elected to accrue those taxes ratably. Therefore, most taxpayers on the accrual basis accrue and deduct taxes in the taxable year in which the accrual date occurs.

Several States have recently enacted legislation which has enabled accrual basis taxpayers to claim that they are entitled to deduct in 1 Federal taxable year property taxes for 2 full property tax years. The technique employed by the State legislatures to accomplish this is simply to cause the accrual event, such as the assessment date, for 2 years' property taxes, to fall within 1 year. Thus, in a State where real property taxes for the calendar year 1961 were assessed and became a personal liability on January 1, 1961, the State legislature would pass a law changing the assessment and personal liability dates for 1962 real property taxes from January 1, 1962, to December 31,

1961. In such a case, the accrual basis calendar year taxpayer might argue that present law permits him to accrue and deduct in the Federal taxable year 1961 the real property taxes assessed for both 1961 and 1962. If the same State continues to assess property taxes for 1963 and all subsequent years on December 31 of the preceding year, the same taxpayer, having claimed the deduction for 2 years' property taxes in 1961, will still claim a deduction for 1 year's taxes in 1962 and for 1 year's taxes in each succeeding year in which taxes are assessed.

This type of State legislation has been widely publicized as being a "tax gimmick." At least one State has specifically provided that for State income tax purposes, the new accrual date shall be disregarded. It is evident that in may cases the primary purpose of such State legislation is to enable accrual basis taxpayers in those States to obtain a Federal income tax benefit.

If the State legislation accomplishes its purpose, a permanent and significant loss of revenue will result and unless remedial legislation is enacted the revenue loss may be significantly increased as other States may well take action similar to that taken by the States mentioned.

To cope with this problem, your committee has included in the bill an amendment which in general would deny an accrual basis taxpayer the right to deduct more than 1 year's State taxes in 1 Federal taxable year. This is done by providing that where the accrual date is earlier than it would be but for any action of any taxing jurisdiction taken after December 31, 1960, such taxes shall be treated as accruing at the time they would have accrued but for such action. This new provision will not apply however, to certain situations where present law properly allows a doubling of deductions, so long as the doubling of deductions is not the result of any action of a taxing jurisdiction.

This section will apply only to taxable years ending after December 31, 1960. Since the section is not retroactive, it is not intended that it apply to taxable years ending prior to January 1, 1961.

VIII. INCOME TAX EXEMPTION AND DEDUCTIONS FOR CERTAIN UNION-NEGOTIATED, MULTIEMPLOYER PENSION PLANS (SEC. 10)

A. GENERAL STATEMENT

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.

Your committee believes these are rather severe consequences, particularly where failure to meet the conditions of the statute for qualification is due to mere inadvertence and 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.

This section therefore provides that with respect to certain stated periods of time the following specified pension trusts are to be considered as qualified trusts.

1. The Iron Workers' Mid-American Pension Fund, for the period beginning on January 30, 1957, and ending on December 16, 1958.
2. The Pattern Makers' Pension Trust Fund of Chicago, for the period beginning on April 28, 1958, and ending on February 24, 1959.
3. The Pipe and Refrigeration Fitters Local 537 Pension Fund of Boston, Mass., for the period beginning on March 1, 1956, and ending on November 9, 1959.
4. The Annuity Plan of the Electrical Switchboard and Panelboard Manufacturing Industry of New York City, for the period beginning May 16, 1956, and ending May 22, 1957.
5. The District Council No. 19 Welfare Fund, now known as Painters District Council No. 19 Welfare and Pension Fund, for the period beginning on January 1, 1954, and ending on August 6, 1956.
6. The Local Union No. 377 Pension Fund, for the period beginning October 13, 1952, and ending April 1, 1958.

B. TECHNICAL STATEMENT

This section provides that certain union-negotiated, multiemployer pension funds shall be deemed to constitute qualified trusts for a specified period of time.

Section 10(a) of the bill provides that the Iron Workers' Mid-America Pension Fund shall be considered to have been a qualified trust under section 401(a) of the Internal Revenue Code of 1954, and shall be considered exempt from tax under section 501(a) of such code, for the period beginning on January 30, 1957, and ending on December 16, 1958.

Section 10(b) of the bill provides that the Pattern Makers' Pension Trust Fund of Chicago shall be considered to have been a qualified trust under section 401(a) of the Internal Revenue Code of 1954, and to have been exempt from tax under section 501(a) of such code, for the period beginning on April 28, 1958, and ending on February 24. 1959.

Section 10(c) of the bill provides that the Pipe and Refrigeration Fitters Local 537 Pension Fund of Boston, Mass., shall be considered to have been a qualified trust under section 401(a) of the Internal Revenue Code of 1954, and to have been exempt from tax under section 501(a) of such code, for the period beginning on March 1, 1956, and ending on November 9, 1959.

Section 10(d) of the bill provides that the Annuity Plan of the Electrical Switchboard and Panelboard Manufacturing Industry of New York City shall be considered to have been a qualified trust under section 401 (a) of the Internal Revenue Code of 1954, and to have been exempt from tax under section 501(a) of such code, for the period beginning May 16, 1956, and ending May 22, 1957.

Section 10(e) of the bill provides that the District Council No. 19 Welfare Fund, now known as Painters District Council No. 19 Welfare and Pension Fund, shall be considered to have been a qualified trust under section 401 (a) of the Internal Revenue Code of 1954, and to have been exempt from tax under section 501(a) of such code and under section 165(a) of the Internal Revenue Code of 1939, for the period beginning January 1, 1954, and ending August 6, 1956. For any taxable year for which this welfare fund is, by reason of the provisions of section 10(e) of the bill, considered to be exempt from tax under section 165(a) of the Internal Revenue Code of 1939, contributions to the fund shall not be allowed as a deduction under section 23(a) of such code.

Section 10(f) of the bill provides that the Local Union No. 377 Pension Fund shall be considered to have been a qualified trust under section 401(a) of the Internal Revenue Code of 1954, and to have been exempt from tax under section 501(a) of such code and under section 165(a) of the Internal Revenue Code of 1939, for the period beginning October 13, 1952, and ending April 1, 1958.

IX. CERTAIN LEASES BY MEDICAL RESEARCH ORGANIZATIONS (SEC. 11)

A. GENERAL STATEMENT

Present law (sec. 514) provides that in the case of educational, charitable, and certain other tax-exempt organizations, the proceeds from certain so-called business leases are to be subject to tax, although the receipt of rent, usually, is not taxed to these organizations. The exception to the general rule as to rental income received by one of these exempt organizations applies where there is indebtedness outstanding with respect to the leased property, or, in other words, where the tax-exempt organization is in effect purchasing the property with the rental income. In such cases, Congress has generally taxed the receipt of rental income because of the belief that in such cases the exempt organizations were in effect using their tax exemption to acquire the property. It has been recognized, however, that where the leased property (although subject to indebtedness) is used for a purpose which is related to the functions of the tax-exempt organization, the motive for obtaining special tax exemption is not likely to be present. As a result, Congress has provided that these business leases are to be taxable only where the operations of the lessee are unrelated to those of the exempt organization.

The attention of your committee has been called to situations where the Internal Revenue Service has defined "related" leases for purposes of this provision in what your committee believes is too narrow a manner. The specific problem presented to your committee was that of a medical research foundation which leases a substantial portion of the buildings which it owns, and in which it is located, to a clinic of doctors. In this case it is understood that the medical foundation relies heavily on treatment of the clinic's patients, medical histories of these patients, and services of the clinic doctors in the conduct of its medical research activities. In fact, it is understood that many of the foundation's research projects could not be carried on without a readily available group of patients, and that several of these projects were first initiated as a result of the observation of the conditions of clinic patients. In addition, clinic doctors provide a readily available reservoir of experience and information for use in the foundation's research. Several doctors split their time between the foundation and the clinic and are compensated proportionately by the two organizations. Most of the clinic doctors customarily donate their services in assisting with many of the foundation's research projects.

In view of your committee's comment in its report on this provision in the Revenue Act of 1950, when this provision was first adopted, your committee believes that the term "related," for purposes of this business lease provision, should include the type of case referred to above. In that report your committee said:

> "Related" is defined in a similar fashion as in the case of a related trade or business and is, for example, intended to exclude from the application of this tax leases by tax-exempt hospitals of part of the hospitals to doctors' associations to use as clinics. It is believed that leases of this type are entered into primarily to further the purpose of the exempt organization rather than to make special benefits from tax exemptions.

Your committee believes that the case cited above is related in a similar manner to the example given of the hospitals and the doctors' clinics. Moreover, it believes that, usually, leases entered into by medical foundations with doctors' clinics are primarily to further the stated purpose of the exempt organization rather than to gain special benefits from tax exemption.

As a result, your committee has added a sentence to the special rules applicable in defining a business lease. This sentence provides that a lease to a medical clinic by a medical research foundation of premises adjacent to those occupied by the foundation shall be considered as "related" if treatment of clinic patients, medical histories of clinic patients, and donated services of clinic doctors are used by the foundation for medical research purposes.

Since the purpose of this amendment is to make explicit the meaning of the term "related" which Congress intended when the tax on unrelated business lease income was first imposed, this provision is made applicable to taxable years beginning after December 31, 1950—the effective date of the tax on business lease income.

B. TECHNICAL STATEMENT

This section amends section 514(b)(3)(A) of the 1954 code, relating to exceptions to the definition of business lease.

Under existing law, exempt organizations subject to the unrelated business income tax imposed by section 511 must include as an item of gross income derived from an unrelated trade or business a percentage of the rentals derived from business leases of their real property. The term "business lease" is defined in section 514(b), and exceptions to this definition are provided in section 514(b)(3). Section 514(b)(3)(A) provides that no lease by an organization shall be considered as a business lease, if it is entered into primarily for purposes which are substantially related (aside from the need for income) to the exercise or performance of the charitable, educational, or other purpose or function which constitutes the basis of the organization's exemption, or if the lease is of premises in a building which is primarily designed for occupancy, and which is occupied, by the organization.

Subsection (a) of section 11 of the bill adds a sentence at the end of section 514(b)(3)(A). This sentence provides that a lease to a medical clinic by a scientific organization engaged in medical research of premises adjacent to those occupied by such scientific organization shall be considered a lease entered into primarily for purposes substantially related to the organization's exempt purposes and functions (and thus shall not be considered a business lease), if the treatment of patients of the medical clinic, their medical histories, and donated services of doctors of the medical clinic are utilized by the scientific organization for medical research purposes.

Under subsection (b) of section 11 of the bill, the amendment made to section 514(b)(3)(A) is effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954 (i.e., years to which the Internal Revenue Code of 1954 applies).

Subsection (b) of section 11 of the bill further provides that a provision having the same effect as the provision added to the Internal Revenue Code of 1954 by subsection (a) shall be deemed to be included in the Internal Revenue Code of 1939 and shall apply with respect to taxable years beginning after December 31, 1950.

X. ATTRIBUTION OF STOCK OWNERSHIP FOR PURPOSES OF PERSONAL HOLDING COMPANY TAX (SEC. 12)

Under the Internal Revenue Code a "personal holding company" generally is any corporation which derives at least 80 percent of its income from certain specified sources if more than 50 percent of its stock is owned directly or indirectly, by or for, not more than five individuals. In determining stock ownership, section 544 of the Internal Revenue Code provides that stock owned by a trust or estate shall be considered as being owned proportionately by its beneficiaries.

However, a question has arisen as to the proper method of attributing the ownership of shares of stock held by a trust if one of its beneficiaries has only a life interest in the trust and other beneficiaries have remainder interests. In such a case the Internal Revenue Service has determined that the life beneficiary is to be considered as owning the entire interest in the trust for purposes of applying the constructive ownership rules in section 544. Thus the interests of remainder beneficiaries are ignored even though in many instances the actuarial value of their interests are as great, or even greater than the interest of the income beneficiary. This action apparently is founded on statements contained in a 1943 opinion of the Tax Court. *Steuben Securities Corporation* v. *Commissioner*, (1 T.C. 395). Recently, however, the U.S. Court of Appeals for the Fifth Circuit apparently rejected those statements in the Tax Court opinion. (*Phinney* v. *Tuboscope Co.*, 268 F. (2d) 233.) In this case, the court held that individuals who did not own a present interest in a trust were clearly beneficiaries within the meaning of the Internal Revenue Code and their interest must be taken into account in applying constructive ownership rules.

Your committee believes that where present and future interests in a trust are held by different persons, it is appropriate that ownership of the assets of the trust be apportioned between them on the basis of an actuarial determination of the value of each interest. In adopting the personal holding company provisions in 1934 Congress stated that stock owned by an estate or trust "shall be considered as being owned proportionately by its * * * beneficiaries." In order to insure that the ownership of a trust will be apportioned among its beneficiaries on an actuarial basis a parenthetical clause is added at the end of section 544(a)(1). This will make it certain that ownership of the entire trust will not be attributed to a beneficiary who only has a life interest.

This section is made applicable to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

XI. CERTAIN DISTRIBUTIONS OF STOCK PURSUANT TO ANTITRUST ORDERS (SEC. 13)

A. SUMMARY OF PROVISION

This section of the bill would add a new section 1111 to the Internal Revenue Code of 1954 which provides, in general, that where a corporation distributes stock in another corporation to its shareholders pursuant to an order enforcing the antitrust laws, gain or dividend income, as othewise determined under existing law, will be recognized, but not in excess of the tax basis to the distributing corporation of the stock received. In the case of a distribution of stock to which this new section applies, the stockholder's tax basis for his total investment after the distribution shall be the same as his former tax basis, increased only by the amount on which he is subject to tax under this section. The proposed new section 1111 is generally similar to the section 1111 proposed by S. 200 (January 12, 1959) as modified by the draft amendment proposed and described by Senator Frear in the course of the hearings on S. 200 (May 26 and 27, 1959). The proposed new section 1111 is identical to the section 1111 proposed by H.R. 8126 reported to the House by the Committee on Ways and Means on September 2, 1959 (H. Rept. 1128, 86th Cong., 1st sess.).

This section of the bill would also add a new section 1112 to provide that if stock is distributed by one corporation to another corporation which, in turn, distributes the stock pursuant to an antitrust order, the recipient of the stock from the second corporation is treated as if he had received the stock directly from the first corporation. The purpose of this provision is to provide the same tax treatment as that provided for in proposed section 1111 to the ultimate recipient of stock which is ordered distributed by an antitrust order but which first passes from one corporation to another corporation before it reaches the ultimate recipient. Under the proposed new section 1112 the corporation which acts merely as a conduit incurs no income tax liability.

The proposed new sections apply only to distributions of stock which take place after the enactment of the bill.

B. REASONS FOR THE PROVISION

Your committee believes that the provisions of this section carry out the policies already established by Congress with respect to the income tax treatment of other situations in which a taxpayer is compelled to divest himself of property as a result of Government action. In these situations it has been considered inappropriate to impose a tax where there is an involuntary realization of gain. The statutory provisions relating to enforced divestitures for which Congress has provided for the deferral of tax include:

(1) Section 1033, insofar as it provides for nonrecognition of gain upon involuntary conversions of property as the result of its seizure, requisition, or condemnation and as the result of the sale of property pursuant to the acreage limitation provisions of Federal reclamation laws.

(2) Section 1071, which provides for the nonrecognition of gain from sales or exchanges of property to effectuate a change in a policy of (or the adoption of a new policy by) the Federal Communications Commission.

(3) Section 1081, which provides for the nonrecognition of gain or loss on exchanges or distributions in obedience to orders of the Securities and Exchange Commission pursuant to the Public Utility Holding Company Act of 1935.

(4) Section 1101, which provides for the nonrecognition of gain in the case of distributions and exchanges made to comply with the provisions of the Bank Holding Company Act of 1956.

In addition, in the Settlement of War Claims Act of 1928, Congress provided that properties sold or exchanged by the Alien Property Custodian were to be treated as involuntary conversions for purposes of the tax law. This treatment also has been ruled to apply where during World War II property has been seized by the United States and subsequently sold by the Alien Property Custodian.

The above provisions of existing law all relate to dispositions required by governmental action. The provisions of this section of the bill also relate to dispositions required by governmental action. Moreover, while this section applies to dispositions required by the longstanding provisions of the Sherman Act and the Clayton Act, your committee believes that it is important to bear in mind that both the Sherman Act and the Clayton Act are expressed in extremely broad terms and that as a consequence antitrust law is developed through judicial decisions over the years. The requirements under the antitrust laws are not static nor is the development of the law readily predictable. An important decision in the antitrust area, such as the decision of the Supreme Court in *United States* v. *E. I. du Pont de*

Nemours and Company et al. (353 U.S. 586 (1957)), may have an effect very similar to the enactment of new legislation requiring divestiture of property. For all of these reasons, this provision would extend to antitrust proceedings the treatment which Congress has already provided in the case of the statutory and administrative provisions referred to above which require divestiture.

In addition to carrying out the policies already established by Congress with respect to the tax treatment of divestitures required by law, your committee also believes that this provision will meet the problems pointed out by the Department of Justice at the public hearings, and will contribute to improved enforcement of the antitrust laws. This will be accomplished by removing the reluctance of defendanrs to accept divestiture in consent decrees where such relief is properly indicated and by making courts more willing to order divestiture where needed without concern as to the tax consequences. In this connection, Hon. Robert A. Bicks, Acting Assistant Attorney General of the Antitrust Division of the Department of Justice, in presenting the views of the Department of Justice before your committee in public hearings on S. 200, testified that—

> Our view is that an appropriately fashioned tax proposal, designed to eliminate tax barriers to antitrust divestiture, would serve the ends of effective antitrust enforcement.

At the hearings before the Committee on Ways and Means of the House of Representatives on H.R. 8126, he also pointed out that—

> * * * the courts may be reluctant to grant divestiture, deeming it "harsh" and "an extraordinarily difficult and expensive undertaking."

Mr. Bicks' fear that it would be difficult to persuade a court to grant a divestiture order seems reasonable in view of what has occurred in the *Du Pont* case, since the time Mr. Bicks testified. At the time he testified, that case was pending in the district court, to which it had been returned by the Supreme Court. On October 2, 1959, the district court gave its decision refusing to order divestiture as requested by the United States (177 Fed. Supp. 1). In its opinion the court said in part:

> The shocking tax impact would impel the court not to order a distribution of General Motors stock by Du Pont, if any other means of removing the effects offensive to the statute are available, and there are such means.
>
> In case tax legislation, such as S. 200, were to pass, this tax result from ordering a distribution would, of course, be eliminated (p. 21).

It was pointed out to your committee that in addition to the large dividend taxes which would result from the distribution of the General Motors stock there would be very substantial sales of General Motors stock by shareholders who needed the money to pay their taxes. These sales would depress the market for that stock to the detriment of the many General Motors shareholders who have no connection whatever with the antitrust litigation.

It may well be that the enactment of this legislation would permit the Department of Justice to obtain an order from the district court requiring divestiture of the General Motors stock. While the district court has heretofore refused to grant such an order, and while the district court's decision is now on appeal to the Supreme Court (which agreed to review the decision on May 23, 1960), it is worth noting that in its opinion of October 2, 1959, the district court reserved jurisdiction of the matter to leave the door open for reconsideration in the event of enactment of legislation changing the tax consequences. The court's decision states in part:

> The court and the parties are aware of the pendency of bills previously referred to which, presumably, will be considered in the 2d session of the 86th Congress and which would, if enacted, substantially ameliorate the tax consequences of a distribution of Du Pont's legal title to the General Motors shares. It is impossible, however, to foretell whether such legislation will be enacted and, if so, the form it will take. Quite possibly a change in policy on the part of the Internal Revenue Service might also affect the tax consequences of any such distribution. The court should not be foreclosed from considering such new legislation or rulings nor should the parties be foreclosed from bringing them to the attention of the court. While a distribution of the legal title to the General Motors shares by Du Pont is not, in the opinion of the court, at all necessary to remedy the effects offensive to the statute in view of the other provisions of the decree to be included, such a distribution would leave a more simplified structure from the corporate standpoint. Consequently, the final judgment should make specific provision for the possibility of such developments and should authorize any party to come before the court and seek modification of the judgment in the light of any such developments (p. 50).

Your committee wishes to make it clear that this legislation will be of great value in facilitating enforcement of the antitrust laws generally and that it is not for the purpose of providing tax relief for any one particular case. It agrees with the statement made by Hon. Robert A. Bicks in the public hearings on H.R. 8126 before the Ways and Means Committee that—

> There is no question that the Du Pont-General Motors litigation has pointed up this problem, thrust the tax barriers to effective and prompt divestiture uppermost in our mind. But it is equally true that this sort of proposal has significance away beyond this particular litigation.

Your committee believes it important to emphasize that, under the bill, the shareholders will be subject to an immediate tax on dividend income and will not be exempted from eventual payment of a tax on any possible appreciation.

The bill does not eliminate the tax on the dividend income which the shareholders would have received if there had been no antitrust violation. This is because the effect of the bill is to cause shareholders, receiving stock in a distribution under an antitrust order, to pay a tax, either on the full amount of the dividend or on an amount equal to the money originally used to purchase the stock distributed. Thus the bill is based on the reasonable assumption that, if the stock had not been purchased, the money used for the purchase would instead have been distributed as a taxable dividend. In effect, the bill treats that as done which ought to have been done. Accordingly, the tax on the dividend income, which would have been received if no antitrust violation had occurred, is not eliminated.

It is further stressed that the bill provides merely for a postponement of the tax on the appreciation in a shareholder's stock and not for an exemption. In the case of a receipt of stock to which the bill would apply, it is required that the shareholder's tax basis for his investment in the distributing corporation before the distribution be used in determining his tax basis for his investment after the distribution, increased only by the amount on which he has paid tax. Thus, when, at any later date, he sells either the stock of the distributing corporation or the stock received, he will be subject to tax in the same manner as if the antitrust distribution had not occurred.

C. GENERAL EXPLANATION OF THE PROVISION

This provision would add a new part IX to subchapter O of chapter 1 of the Internal Revenue Code of 1954. The new part IX consists of two sections, both of which deal with distributions of stock to shareholders pursuant to orders enforcing the antitrust laws. Section 1111 relates to distributions made by the corporation which held such stock directly to an individual or corporate shareholder. Section 1112 relates to a case in which, pursuant to an antitrust order (or orders), a corporation receives stock and must distribute it again to its own shareholders.

Section 1111

The new section 1111 applies where a corporation distributes to its shareholders stock which, in their hands, is "divested stock" as defined in section 1111(f). Such stock must be the subject of a judgment, decree, or other order of a court or of a commission or board in a suit or proceeding under the Sherman Act or the Clayton Act, or both, to which the United States or such a commission or board is a party. Distributions of such stock are taxed as follows:

(1) If the distribution is treated as a dividend (i.e., is a distribution to which sec. 301 applies) the amount of the distribution, for purposes of computing the dividend tax, may not exceed the average basis to the distributing corporation of the divested stock;

(2) if the distribution consists solely of divested stock, is in exchange for stock of the distributing corporation, and is treated as a sale or exchange, the shareholder's gain may not exceed the average basis to the distributing corporation of the divested stock.

The determination of the amount of the distribution under section 1111 in the case of distributions treated as dividends is substantially the same as the determination under section 301 of the 1954 Code in the case of distributions of property to corporate shareholders. This same approach is applied under the new section 1111 to limit the recognition of gain in the case of exchanges of divested stock where such exchanges are treated as in payment for the stock of the distributing corporation surrendered.

Under existing law, on a distribution of property in kind to an individual shareholder the amount of the dividend is determined by the fair market value of the property distributed. The new section 1111 which would be added by the bill provides for a different treatment in view of the involuntary nature of the distribution. The so-called section 301 approach adopted by the new section 1111, by imposing an immediate dividend tax of an amount equal to the cost to the distributing corporation of the divested stock, contains a built-in safeguard in the case of recent corporate acquisitions. The new section will aid the enforcement of the antitrust laws primarily in those cases in which the divested stock has a low basis relative to its fair market value. Such a low basis would exist ordinarily where the divested stock had been acquired by the distributing corporation many years prior to the court order requiring divestiture.

Under the so-called section 301 approach adopted by the new section 1111, gain or dividend income will qualify for nonrecognition treatment only to the extent that it is attributable to unrealized appreciation in the hands of the distributing corporation. Thus, the portion of the dividend income which is recognized will be equal to that which would have been recognized if the distributing corporation had originally not purchased the stock resulting in the antitrust violation, but had instead, at that time, distributed the money as a cash dividend.

The approach adopted by your committee differs from the approach applied under section 301 in the case of corporate shareholders in two important respects: First, under the new section 1111, the shareholder's gain or dividend income, as the case may be, is determined by reference to the average adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the divested stock, such average adjusted basis being determined under regulations prescribed by the Secretary or his delegate. Under section 301, the amount of dividend income in the case of a corporate shareholder is determined by reference to the adjusted basis to the distributing corporation of the identifiable property received by the particular corporate shareholder. The average adjusted basis rule provided under the new section 1111 is applicable to all shareholders, corporate or individual. In addition, it is provided under the new section 1111 that in the case of a dividend distribution the shareholder's basis for his stock in the distributing corporation, increased by the amount of gain taxed to the shareholder, is allocated between the divested stock received and the stock with respect to which the distribution is made on the basis of the fair market values of such stocks immediately after the distribution. Under section 301 of existing law no allocation of basis is made in the case of a distribution of property to a corporate shareholder. The allocation of basis provided under the new section 1111 is applicable both to individual and to corporate shareholders. However, under proposed section 1112 certain special exceptions are made to the rules of section 1111 if a recipient corporation must again distribute the stocks pursuant to an antitrust order.

The new section 1111 does not apply in the case of distributions to avoid Federal income tax. Section 1111(a)(4) provides that nonrecognition treatment shall not be accorded to any transaction one of the principal purposes of which is the distribution of the earnings and profits of the distributing corporation or of the corporation whose stock is distributed, or both. This provision is generally the same as that contained in section 355(a)(1)(B) of the 1954 Code (relating to distributions of stock and securities of a controlled corporation) and is for the purpose of insuring that nonrecognition treatment shall be denied in the case of any distribution of divested stock pursuant to a court order if the distribution is part of a plan with a principal purpose of avoiding dividend tax on a distribution of earnings and profits. Your committee believes it desirable to make clear that the mere fact that either corporation has accumulated earnings and profits shall not be construed to mean that one of the principal purposes of the transaction is the distribution of the earnings and profits of either corporation, or both.

Subsection (f)(1) of the new section 1111 defines the term "divested stock." Divested stock is defined as stock which is the subject of an antitrust order entered after June 1, 1959, meeting the following conditions:

(1) The order must direct the corporation to divest itself of such stock by distributing it to its shareholders, or must require such distribution as an alternative action.

(2) The order must specify and identify the stock to be divested.

(3) The court must find divestiture necessary or appropriate to effectuate the policies of the antitrust laws.

(4) The court must find that the partial nonrecognition treatment provided by subsection (a) is required to reach an equitable antitrust order in such suit or proceeding.

It is also provided that stock shall not be divested stock if the court order finds its divestiture is required because of a violation of the antitrust laws which was intentional.

Subsection (f)(2) of the new section 1111 provides that notwithstanding the definition of "divested stock" contained in subsection (f)(1), shares of stock shall not be divested stock unless the court finds, as to such shares of stock, that following the distribution or distributions of such shares to a shareholder (or to a group of shareholders found to be cohesive by reason of their business interests or other relationships or for other reasons found by the court) and following the application of other provisions of the antitrust order, there will not be power in such shareholder, or group of shareholders, to influence the commercial relations of more than one of the corporations whose stock is being distributed, or of the distributing corporation and one or more of the corporations whose stock is being distributed, to the competitive advantage of the distributing corporation or one or more of the corporations whose stock is distributed.

The provision described in the preceding paragraph is for the purpose of insuring that this section will be available only where necessary for effective antitrust relief. There will not be nonrecognition treatment in cases where, with respect to particular shares of stock, a sale or other disposition or arrangement would be more appropriate under the antitrust laws than a distribution of such stock. In the absence of this provision, it is believed that courts might be most reluctant to order a sale of stock (which would have substantial tax consequences) if the statute permitted limited tax consequences on a distribution of such stock if ordered by the court. Section 1111(f)(2) will make it unnecessary for a court to choose between these alternatives because the benefits of the bill will be available only where distribution is completely compatible with antitrust objectives. If it is shown that following a distribution and after compliance with all the provisions of an antitrust order, such as prohibitions on interlocking directorates and voting of stock, any stockholder or group of stockholders will be in a position to act improperly under the policies of the antitrust laws, as set forth in the bill, those shareholders will be denied the benefits of the bill. Their disqualification will, of course, in no way affect the balance of the shareholders.

Proposed new section 1111 is effective only with respect to distributions of divested stock made after the date of enactment.

Section 1112

Section 1112 provides that if stock is distributed by one corporation to another corporation which, in turn, distributes the stock pursuant to an antitrust order, the recipient of the stock from the second corporation is treated as if he had received the stock directly from the first corporation. The purpose of this provision is to provide for the same tax treatment to individuals receiving divested stock, whether they receive such stock directly from the first distributing corporation, or whether they receive such stock indirectly through one or more intermediate holding companies. Under this section, if a corporation receives stock pursuant to an antitrust order and has to distribute it within 1 year from such receipt, also under an antitrust order, such a conduit corporation incurs no income tax liability, although the basis of its stock in the distributing corporation is readjusted because of section 1111. In determining the tax treatment of an individual shareholder who ultimately receives the divested stock, the basis of such stock to the conduit corporation and the earnings and profits of the conduit corporation are not taken into account.

Section 1112 applies only to distributions of stock which take place after the date of enactment.

D. TECHNICAL EXPLANATION OF THE AMENDMENT

The amendment amends subchapter O of part I of the Internal Revenue Code of 1954 by adding a new part IX consisting of two new sections, section 1111 and section 1112. Both sections limit the amount includible in income in the case of distributions of stock pursuant to certain orders enforcing the antitrust laws. Stock eligible for the special treatment provided must be "divested stock" as defined in section 1111.

Section 1111. Distribution of stock pursuant to orders enforcing the antitrust laws

Section 1111(a)(1) defines a "distribution of divested stock" to include a distribution by a corporation to a shareholder, with respect to his stock in the distributing corporation, whether or not the distribution is pro rata with respect to all the shareholders of the corporation and whether or not the shareholder surrenders any of his stock in the distributing corporation. If the shareholder receiving a distribution of divested stock is a corporation, a further distribution to its shareholders may also constitute a distribution of divested stock.

Section 1111(a)(2) provides that the amount of the distribution, for purposes of section 301 of the code, shall be the fair market value of the divested stock or the average adjusted basis of such stock in the hands of the distributing corporation immediately before the distribution, whichever is less. For example, shareholder A owns 20 shares of common stock of corporation X. Pursuant to an antitrust order, corporation X distributes 2 shares of stock in corporation Y, which qualify as divested stock, for each share of common stock of corporation X outstanding. The amount of divested stock of corporation Y owned and distributed by corporation X is 1,000 shares, 500 of which have a basis to corporation X of $20 a share and 500 of which have a basis to corporation X of $40 a share. Thus, the average adjusted basis of the corporation Y stock to corporation X is $30 a share. The fair market value of such divested stock at the time of the distribution is $100 a share. The amount of the distribution for purposes of section 301 of the code is $30 a share (the average adjusted basis to corporation X). Accordingly, the amount of the distribution to shareholder A for purposes of section 301 is $1,200 (40 shares times $30).

Section 1111(a)(3) limits the amount of gain to be recognized where the shareholder surrenders stock in the distributing corporation solely for divested stock which is treated as in part or in full payment therefor. In such a case the gain may not exceed the average adjusted basis of the divested stock in the hands of the distributiing corporation immediately before the distribution. For example, shareholder B owns 5 shares of common stock of corporation Y. B surrenders his 5 shares to corporation Y for 10 shares of divested stock in corporation Z in a redemption which is treated as a distribution in payment for the stock under section 302(a). The basis to B of the stock surrendered is $200. The fair market value of the divested stock in corporation Z received by B is $500 and it has an average adjusted basis to corporation Y of $10 per share. The amount of gain realized by shareholder B on the exchange is $300 ($500 fair market value of corporation Z stock received less $200 basis of corporation Y stock surrendered). The amount of such gain recognized is limited to $100 (the average adjusted basis of corporation Z stock in the hands of corporation Y times the number of shares received by B).

Section 1111(a)(4) provides that the special rules of section 1111(a)(2) and (3) will not apply to any transaction one of the principal purposes of which is the distribution of the earnings and profits of the distributing corporation or the corporation whose stock is distributed, or both. The fact that stock was purchased in contemplation of an antitrust order requiring its distribution may be evidence of the prohibited tax avoidance purpose. Even if such contemplation did not exist at the time of acquisition, such a principal purpose might nevertheless be found to exist because of events occurring after such acquisition. However, the fact that an antitrust order requires, in the alternative, either a sale by the corporation or a distribution to shareholders, and the corporation elects to distribute the stock in order to minimize tax consequences, would not of itself be sufficient to show that one of the principal purposes of the transaction is the distribution of earnings and profits. The existence of accumulated earnings and profits in either the distributing corporation or the corporation whose stock is distributed would not in itself mean that such a purpose existed. The fact that stock is divested stock within the meaning of section 1111(f) is not conclusive upon the issue of whether one of the principal purposes of the transaction is the prohibited tax avoidance purpose. Thus, even if the court, commission, or board does not find an intentional violation of the Sherman Act or the Clayton Act and does find that the application of section 1111(a) is required to reach an equitable antitrust order, the Commissioner of Internal Revenue may make an independent determination as to whether such a purpose existed.

Section 1111(a)(5) provides that the average adjusted basis of divested stock shall be determined under regulations prescribed by the Secretary or his delegate.

Section 1111(a)(6) defines the term "stock" to include rights to receive fractional shares.

Section 1111(b)(1) provides rules for determining the basis of the divested stock and of the stock of the distributing corporation in the case of a distribution of divested stock the amount of which was determined under section 1111(a)(2). Under section 1111(b)(1) the adjusted basis, immediately before the distribution, of the stock with respect to which the distribution was received is allocated between such stock and the divested stock received in accordance with regulations. Such adjusted basis is increased by an amount treated as a dividend or as gain from the sale or exchange of property under section 301(c)(3)(A) of the code. For example, shareholder A owns one share of common stock of corporation X which has a basis to him of $80. Corporation X distributes to shareholder A one share of divested stock in corporation Y. The corporation Y stock has an average adjusted basis to corporation X of $20 a share and a fair market value of $60 a share. The amount of the distribution to shareholder A is $20, which is taxed as a dividend pursuant to section 301 of the code. After the distribution shareholder A as a total basis for both his corporation X stock and corporation Y stock of $100, that is, $80 (A's basis for his share of stock in corporation X) plus the $20 treated as a dividend. Following the distribution, A's corporation X stock has a fair market value of $140 and his corporation Y stock has a fair market value of $60, for a combined total of $200. Assume that, under regulations prescribed by the Secretary or his delegate, A's total basis of $100 is allocated between his corporation X stock and his corporation Y stock in accordance with their fair market values. A's basis for his corporation X stock will be 140/200 of $100, or $70, and his basis for his corporation Y stock will be 60/200 of $100, or $30. However, section 1112 modifies this rule of allocation in a case where the stock received is again distributed as divested stock.

Section 1111(b)(2) provides a rule for determining the basis of divested stock received in exchange for stock in the distributing corporation and with respect to which the amount of gain recognized was determined under section 1111(a)(3). In such case the basis of divested stock received is the same as that of the stock in the distributing corporation surrendered by the shareholder, increased by the amount of any gain recognized upon the exchange. For example, shareholder A owns one share of common stock of corporation X which has a basis to him of $80. Corporation X distributes to shareholder A two shares of divested stock in corporation Y in full payment in exchange for his share of common stock of corporation X. The stock of corporation Y received by shareholder A has a fair market value of $100 a share and an average adjusted basis to corporation X of $30 a share. The amount of gain recognized to shareholder A is limited to $60 (the average adjusted basis to corporation X of the two shares received by A). After the exchange the total basis of the two shares in A's hands is $140 (the basis of the corporation X stock surrendered in the exchange, $80, plus the amount of gain recognized on the exchange, $60).

Section 1111(c) provides that a proper allocation of earnings and profits shall be made under regulations prescribed by the Secretary or his delegate where the divested stock distributed under section 1111(a) (2) or (3) is stock in a corporation controlled by the distributing corporation. Control is defined as the ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock.

Section 1111(d) defines the term "antitrust order" and, under section 1111(f), only stock which is the subject of an antitrust order as so defined may qualify as divested stock. An "antitrust order" is a judgment, decree, or other order of a court or of a commission or board in a suit or proceeding under the Sherman Act or the Clayton Act, or both, to which the United States or such a commission or board is a party.

Section 1111(e) defines the term "court" to include a commission or board issuing an "antitrust order."

Section 1111(f)(1) defines the term "divested stock" to mean stock which is the subject of an antitrust order entered after June 1, 1959. The order must direct the distributing corporation to distribute the stock to its shareholders (or require such distribution as an alternative to other action by any person) and further must specify and itemize the stock to be divested. It is further required that the court issuing the antitrust order must find that the divestiture of the stock is necessary or appropriate to effectuate the policies of the Sherman Act, or the Clayton Act, or both, and must also find that the special tax treatment provided by section 1111 is required to reach an equitable antitrust order in the suit or proceeding. Section 1111(f)(1) further provides that no stock shall be divested stock if the court finds that divestiture is required because of an intentional violation of the Sherman Act or the Clayton Act, or both.

Section 1111(f)(2) excepts certain stock from the definition of divested stock even though it may otherwise qualify as divested stock under the rules of section 1111(f)(1). This section provides that shares of stock shall not be divested stock unless the court finds, as to such shares of stock, that following the distribution or distributions of such shares to a shareholder (or to a group of shareholders found to be cohesive by reason of their business interests or other relationships or for other reasons found by the court) and following the application of other provisions of the antitrust order, there will not be power in such shareholder, or group of shareholders, to influence the commercial relations of more than one of the corporations whose stock is being distributed, or of the distributing corporation and one or more of the corporations whose stock is being distributed, to the competitive advantage of the distributing corporation or one or more of the corporations whose stock is distributed. Under section 1111(f)(2) the court may limit such finding to some of the shares distributed pursuant to the antitrust order, and only those shares as to which the finding was not made will fail to qualify as divested stock by virtue of section 1111(f)(2).

Section 1111(g) provides that for purposes of determining control under section 351 of the code, dispositions of divested stock received in a distribution to which section 1111(a) applies shall not be taken into account if such dispositions are required by an antitrust order. Thus, if corporation X transfers assets to corporation Y in exchange for all of corporation Y's stock and distributes the corporation Y stock to its shareholders in a distribution to which section 1111(a) is applicable, corporation X will be deemed to have acquired control of corporation Y for purposes of section 351 of the code even though, in obedience to the antitrust order, the shareholders of corporation X immediately dispose of the corporation Y stock received by them.

Section 1111(h) provides certain cross references.

Section 1111 applies only to distributions of stock which take place after the date of enactment.

Section 1112. Successive distributions of divested stock

Section 1112 provides that if (1) a corporation is a distributee of divested stock in a distribution to which section 1111(a)(2) applies, and (2) such distributee is required to redistribute the stock received by an antitrust order within 1 year from the time of receipt (or such longer period as the Secretary of the Treasury may provide), and (3) such redistribution is also a distribution of divested stock to which section 1111(a)(2) applies, then no gain or loss shall be recognized to (and no amount shall be includible in the income of) the redistributing corporation on the receipt of such divested stock.

Section 1112 further provides that a shareholder receiving divested stock from a redistributing corporation shall have his tax determined as if he had received such stock directly from the corporation originally distributing it. Thus, the allocation of basis in the hands of the conduit corporation, and the earnings and profits of such corporation have no effect on the determination of the tax of a shareholder receiving divested stock through it.

Section 1112 applies only to distributions of stock which take place after the date of enactment.

Amendment to section 1223, holding period of property

Section 13 of the bill also amends section 1223 of the code to make it applicable to stock distributions to which proposed sections 1111 and 1112 apply to limit the income realized.

XII. GIFT TAX TO BE INCLUDED IN GROSS ESTATE IN CERTAIN CASES, ETC. (SEC. 14)

A. INCLUSION OF GIFT TAX IN GROSS ESTATE

Under present law a gift made within 3 years of the donor's death is presumed to have been made in contemplation of death. If it is found to have been so made the value of the gift is required to be included in the donor's gross estate and, as described below, a credit against the estate tax is allowed for the gift tax paid at the time the gift was made. This treatment was designed to place the estate of the decedent in the same position it would have been had no gift, in fact, been made. Present law, however, does not fully accomplish this purpose. Under such circumstances, the donor's overall estate tax burden is reduced because the gift tax is permitted to offset estate tax liability even though the amount of the gift tax *per se* is not included in the estate tax base.

This provision of the bill, which is added by your committee, requires that where a gift is subsequently included in the donor's gross estate (for example, where it was made in contemplation of death) the gift tax paid on that gift also is to be included in the gross estate. Your committee believes that this amendment serves to restore the estate to the same position it would have been if no gift had been made. In such a case the gross estate would have been larger, not only by the value of the gift, but also by the amount of the gift tax. This amendment eliminates what your committee believes is a device whereby taxpayers have been able to reduce their estate tax burden simply by making deathbed gifts. Under the bill this amendment will apply with respect to gifts made after the date of enactment of this bill.

B. CREDIT FOR GIFT TAX

Present law allows a credit against the estate tax for any gift tax paid with respect to gifts of property which subsequently are required to be included in the gross estate. The credit is subject to two limitations. First, it cannot exceed the gift tax paid with respect to that property. Second, the credit cannot exceed the estate tax attributable to the inclusion of the gift in the gross estate. This is determined by a ratio which generally relates the value of the gift to the value of the gross estate. However, because the estate tax is imposed upon the taxable estate, not the gross estate, in a case where debts must be paid from probate property the ratio does not truly reflect the proportion of the taxed property which the gift property actually represents.

Thus under this ratio an estate with unpaid debts at the date of the decedent's death may receive a smaller gift tax credit than that received by another estate having the same taxable estate but no indebtedness, even though both decedents made the same gifts and paid the same gift tax. This may be illustrated by the following example:

	Decedent A	Decedent B
1. Gross estate	$250,000	$150,000
Less outstanding debts	100,000	
Net estate	150,000	150,000
2. Amount of gift included in gross estate	50,000	50,000
3. Prior gifts (above annual exclusion)	30,000	30,000
4. Gift tax paid on gift in line 2	5,250	5,250
5. Net estate	150,000	150,000
6. Estate tax on net estate in line 5	17,500	17,500
7. Gift tax credit with limitation based on gross estate	[1] 3,500	[2] 5,250

[1] $\frac{50,000}{250,000} \times \$17,500 = \$3,500.$

[2] $\frac{50,000}{150,000} \times \$17,500 = \$5,833$ (but not to exceed the gift tax paid).

Your committee believes that full credit should be permitted for gift tax paid where the gift property subsequently is included in the donor's gross estate. To accomplish this purpose, and thereby eliminate what the Treasury Department concedes is an inequity in the present law, the bill makes two amendments with respect to the above-described ratio.

First, a technical amendment is made to section 2012(a) to relate gifts to the taxable estate rather than the gross estate. This provision is made applicable with respect to decedents dying after the date of enactment of this bill. However, because of the next amendment, described below, this technical amendment will continue to be effective only with respect to such decedents in the case of gifts made before the enactment of this bill. Second, the bill adds a new provision to the Internal Revenue Code which makes the above-described ratio inoperative where a gift tax, as well as the gift property, is included in the gross estate. Because gift tax will be included in the gross estate only with respect to gifts made after the date of enactment of this bill, this second amendment also will apply only with respect to gifts made after the date of enactment of this bill.

XIII. IMPORT TAX ON LEAD AND ZINC (SEC. 15)

The lead and zinc mining industry of the United States has for several years tried all of the various avenues provided by law which might lead to the regulation of imports so that domestic mines and smelters might operate on a sound and stable basis. The Tariff Commission recently concluded its fourth study since mid-1954. Two of these studies were pursuant to section 7 of the Trade Agreements Act, or escape-clause investigations. In both of these the Commission was unanimous in a finding of injury to the domestic industry.

On June 19, 1958, the President announced that he was suspending consideration of the Commission's recommendation with respect to lead and zinc, stating that a final decision would be appropriate after the Congress completed its consideration of the minerals stabilization plan, presented with his approval by the Secretary of the Interior.

Congress did not approve the proposed minerals stabilization plan, and on September 22, 1958, the President announced that he had accepted the unanimous finding of the Commission that escape clause relief was warranted. Effective October 1, 1958, the President limited imports of unmanufactured lead and zinc to 80 percent of the average annual commercial imports during the 5-year period 1953–57.

Such quotas have been in effect since that date and in recent months the Finance Committee has received many appeals for changes in the method of import regulation. Without regard to the merits of the quota system during its first year of operation, there is evidence from many sources that a change now is not only desirable but imperative.

The Tariff Commission in its report issued in March 1960, unanimously made the following statement (pp. 109–110):

> In summary, import quotas affecting such a large and complex industry as lead and zinc have not proved a satisfactory means of curtailing excessive imports of these metals. The quotas adopted are rigid and inflexible and, being incapable of adjusting the changing elements of domestic supplies to the changing and varied needs of industrial consumers, have tended to increase, rather than to reduce instability of market prices, and thereby to thwart the best

interests both of domestic producers and consumers of lead and zinc. The system of import quotas has been discriminatory in its effects upon various producers, importers, and consumers, and has created unusual difficulties for some while it has brought windfall advantages to others. In zinc smelting, especially, the absolute quota system has tended to eliminate small, though efficient, producers who, with little or no control over domestic ore supplies, are rendered increasingly dependent upon precarious foreign ore supplies. On the one hand, this has tended to reduce nearby markets for ores produced by domestic mines in areas near the location of such smelters. On the other hand, it has tended to concentrate control over domestic ore supplies in the hands of a few powerful integrated corporations, and, with imports strictly limited by quotas, to increase their control over domestic supplies and market prices. Finally, import quotas have seriously interfered with normal trade relations between smelters or importers and their suppliers and between producers or importers and their customers, thereby forcing unusual, unnatural, vexing, and often uneconomic, adjustments.

At the public hearing before the Tariff Commission in January 1960, all interested parties, domestic and foreign alike, spoke against continuance of import quotas. Even the representatives of the domestic lead- and zinc-mining industry, which the quotas were designed to protect, made no defense of them and proposed import duties or import taxes in place of quotas.

The Finance Committee, because of the urgency of the matter, adopted an amendment to H.R. 5547 which would combine the best features of several proposals made respectively by representatives of the Department of the Interior, by the mining industry, and by the processing industry. It is assumed that the amendment would serve to replace the quotas now in effect.

The amendment would add to chapter 38 of the Internal Revenue Code of 1954 (relating to import taxes) a new subchapter providing for the following:

Import taxes on lead:

On lead-bearing ores, flue dust, and mattes of all kinds, 1.4 cents per pound on lead content.

On lead bullion and lead in pigs, bars, etc., 2 cents per pound on lead content.

And, in addition, if the average market price of lead falls below 13½ cents per pound, further taxes at the rate of 0.7 cent per pound on the lead content of ores, flue dust, etc., and 1 cent per pound on the lead content of bullion, pigs, bars, etc. However, when the price of lead is determined to be 14½ cents per pound or more, the additional taxes shall cease to be imposed. A compensatory tax of 2 cents per pound would be imposed on lead products.

Import taxes on zinc:

On zinc fume, 1.05 cents per pound on zinc content.

On zinc-bearing ores, containing not more than 3 per centum of zinc, 1.05 cents per pound on the zinc content.

On zinc in blocks, pigs, or slabs, 1.5 cents per pound.

On zinc scrap and skimmings, 1.05 cents per pound.

In addition, if the average market price of zinc falls below 12½ cents per pound, further taxes shall be imposed at the rate of 0.7 cent per pound on the zinc content of zinc fume and the same on zinc-bearing ores; 1.0 cent per pound on zinc in blocks, pigs, or slabs; and 0.7 cent per pound on zinc scrap and skimmings. When the price of zinc is determined to be 13½ cents per pound or more, these additional taxes shall cease to be imposed. A compensatory duty of 1.8 cents per pound on the zinc content of manufactured products would also be applied.

The above amendment adopted by the Finance Committee contains features of one industry recommended proposal for a straight tax regardless of the price of lead or zinc as well as features of another industry proposal for an entirely flexible or removable tax. It retains the advantage of a moderate permanent tax plus a small additional removable tax based on the respective prices of lead and zinc. It avoids the disadvantages of a full permanent tax which would continue in effect even when prices are adequate and protection not necessary; at the same time it would prevent the sudden substantial price changes which would inevitably accompany the assessing of the full tax whenever the price dropped below the peril point.

The amendment contains elements of the proposal made in 1957 by representatives of the Department of the Interior and incorporates the moderate maximums recommended by the members of the Tariff Commission which offered suggestions for the replacement of the present quotas. The maximum taxes in the amendment also approximate those in the earlier suggestions of the spokesmen for the executive departments.

Before making its decision the Committee gave careful consideration to another proposal made by a portion of the industry which would levy taxes at a somewhat higher rate but which would be removed entirely when prices reached specified levels. This proposal would assess taxes on lead-bearing ores at the rate of 2.8 cents per pound on the lead content and 4 cents per pound on lead in bars, pigs, etc.; and taxes on zinc at the rate of 2.8 cents per pound on the zinc content of ores and 4 cents per pound on zinc in blocks, pigs, etc. These taxes would not be applied at all when prices reach the respective levels of 15½ cents per pound for lead or a combined price of 29 cents per pound for lead and zinc, or of 13½ cents per pound for zinc or a combined price of 29 cents for lead and zinc.

The committee rejected this proposal in favor of the amendment which provides for a permanent tax plus an additional removable tax.

XVI. DISTILLED SPIRITS AND WINES FOR USE OF FOREIGN EMBASSIES, LEGATIONS, ETC. (SEC. 16)

A. GENERAL STATEMENT

Under present law, foreign diplomats stationed in this country are not permitted to purchase domestic distilled spirits and wine without paying the U.S. tax although U.S. diplomats stationed in most foreign countries are allowed to purchase similar commodities in those countries tax free. On the other hand, foreign diplomats stationed in the

United States may obtain imported distilled spirits and wine from a customs bonded warehouse tax free.

This situation has resulted in two discriminations. First, taxed domestic distilled spirits and wine are unable to compete successfully against tax-free imported spirits and wine for the diplomatic trade. Second, foreign diplomats stationed in this country are placed in a less favorable position with respect to the purchase of domestic spirits and wine than are U.S. diplomats stationed in a foreign country.

Your committee's bill removes both of these inequities. It provides a procedure whereby foreign diplomats may obtain domestic distilled spirits and wine on a tax-free basis. This is done by permitting them to withdraw such commodities from a customs bonded warehouse tax and duty free in the same manner imported spirits and wine presently may be withdrawn. Under the bill, domestic spirits and wine withdrawn tax free may be used only for the official or family use of foreign governments, organizations, and individuals who are permitted to import distilled spirits or wine tax free.

Amendments made by this section will take effect 3 months after the date of enactment of this bill.

B. TECHNICAL STATEMENT

This section was added to the House bill by your committee to provide a procedure whereby American distilled spirits and wines may be withdrawn free of tax for consumption in the United States for the official or family use of foreign governments, organizations, and individuals who are entitled to import distilled spirits or wines free of tax.

The section redesignates section 5066 of the Internal Revenue Code of 1954 as section 5067 and adds a new section 5066 entitled "Distilled Spirits and Wines for Use of Foreign Embassies, Legations, etc."

Subsection (a) of new section 5066 provides for the entry into customs bonded warehouses of distilled spirits bottled in bond for export, bottled distilled spirits eligible for export with benefit of drawback, and of specified bottled wines labeled for export. Such distilled spirits and wines will be entered into customs bonded warehouses in which imported distilled spirits and wines are permitted to be stored in bond.

In general the distilled spirits and wines will be handled under the procedures applicable to the exportation of such commodities and the entry into customs bonded warehouses, as provided in subsection (a), of distilled spirits and wines will be held to have the same effect as though the distilled spirits or wines so entered were exported.

Paragraph (1) of subsection (b) provides for the withdrawal from customs bonded warehouses of distilled spirits and wines entered into such warehouses under the provisions of subsection (a). This subsection provides that pursuant to regulations, distilled spirits or wines so entered may be withdrawn for consumption in the United States by and for the official or family use of foreign governments, organizations and individuals who may now or hereafter be entitled to withdraw imported distilled spirits or wines from such warehouses free of tax. The distilled spirits and wines will be withdrawn in the same manner and under the same conditions and procedures as distilled spirits or wines imported and withdrawn free of tax by such governments, organizations, and individuals. It is intended that all conditions applicable to the withdrawal of imports (for example the reciprocity condition contained in sec. 7511 of the Internal Revenue Code) be applicable in respect to withdrawal of domestic distilled spirits and wines from such customs warehouses.

Paragraph (2) of subsection (b) provides that no distilled spirits or wines withdrawn from such customs bonded warehouses for use of such governments, organizations, or individuals or otherwise brought into the United States free of tax for such use, shall be sold, possessed, or disposed of for use or uses other than as provided in subsection (b). This provision applies to all distilled spirits and wines, whether imported or domestic, which are withdrawn from such customs-bonded warehouses for use of such governments, organizations, or individuals or which are otherwise brought into United States free of tax for such use. This provision is intended to make applicable criminal and forfeiture provisions of the Internal Revenue Code with respect to all such distilled spirits or wines, imported or domestic, which are sold, possessed, or disposed of for use or uses other than as provided in this section.

XVII. 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).

MINORITY VIEWS OF SENATOR DOUGLAS AND SENATOR GORE

THE DU PONT AMENDMENT (SEC. 13)

We are opposed to the amendment (sec. 13 of the bill) which would provide very great tax relief for the individual stockholders of the Du Pont Corp. in the event the court ordered Du Pont to divest itself of its General Motors holdings.

COURT CASE STILL PENDING

In the first place, there is no present need for this bill. The case is still pending in the courts. No divestiture has yet been ordered. An appeal from a district court decision, which did not order divestiture, is still pending. The case will not be before the Supreme Court for some time and even after it is heard it will have to be sent back to the district court for whatever action is ordered.

It would certainly seem the better course of action to wait for these court decisions in order to determine what relief, if any, is justified. Further, if no divestiture is ordered, no relief will ever be necessary.

TAX EFFECTS IF DIVESTITURE IS ORDERED

What would be the tax effects of this bill if the courts ordered Du Pont and its family-controlled corporations, Christiana and Delaware Realty Corps., to divest themselves of General Motors stock? We should first establish some facts.

Of the 63 million shares of General Motors stock now owned by Du Pont, roughly 65 percent is owned by individuals, 29 percent by Christiana and Delaware Realty (controlled by the Du Pont family), and 6 percent by other corporations. At the present time these shares are worth about $45 apiece, or $2.8 billion. The original cost of the General Motors stock to the Du Pont Corp. was about $2.10 per share.

Under present law

What would be the tax consequences under present law if divestiture were ordered?

(1) Under the present law, the shares owned by individuals would be taxed as dividend income, estimated (for purposes of revenue effect determination) to be at an average rate of 50 percent to these shareholders. This would bring in revenues of $900 million.

(2) If Christiana and Delaware Realty were ordered to divest themselves of General Motors stock, these shares would also go to individuals and the tax would also be at the dividend income rate again, for revenue effect determination, to be at an average of 50 percent for these individuals. This would bring in revenues of approximately $400 million.

(3) The 6 percent of the stock now owned by corporations other than Christiana and Delaware Realty would be taxed at only about 16

cents per share, or a tax of about $604,000. This is true because dividends distributed between corporations are taxed on the basic value of the shares ($2.10 in the case of Du Pont) and there is an 85-percent intercorporate dividend deduction ($2.10 less 85 percent equals 32 cents times effective tax rate of 50 percent equals 16 cents).

Under the Du Pont amendment

Under the Du Pont amendment to the bill, these tax consequences would be enormously reduced.

(1) The shares owned by individuals would be taxed at the "basis cost" to Du Pont. Since this is $2.10 and these groups would pay about a 50 percent effective tax rate on the average, the tax would be about $1.05 per share instead of $22.50 per share. The tax revenues would be reduced from about $900 million under present law to about $43 million under the bill, or a loss in revenues of over $850 million.

(2) The shares owned by Christiana and Delaware Realty would also be taxed at $1.05 instead of $22.50. This would bring in $19 million instead of about $400 million, or a tax loss of about $380 million.

If Christiana and Delaware Realty were not required to divest, the tax would be only 16 cents per share (i.e., 52 percent of 15 percent of $2.10). On holdings of 18.3 million shares, the total tax for Christiana and Delaware Realty would be only $3 million.

(3) The 6 percent of the shares owned by other corporations would be taxed at the same effective rate as under present law, or about 16 cents per share, and there would be no effective tax changes.

The total tax losses would be the difference between taxes at $1.3 billion and taxes at $62.6 million, or about $1.23 billion.

The following table may help to make this clear.

Tax effects if Du Pont were ordered to divest itself of General Motors stock

Class	Shares of General Motors stock now indirectly held (millions)	Percent	Estimated tax under present law (millions)	Estimated tax under amendment to this bill (millions)
Individuals	40.9	65	$900	$43
Stockholders of Christiana and Delaware Realty	18.3	29	400	19
Other corporations	3.8	6	.6	.6
Total	63	100	1,300	62.6

CONCLUSIONS

Certainly such potential tax relief is neither necessary nor in the public interest. This is especially true since the courts have not even settled the case. The effect of such a tax law, in this as well as in other cases, would be an incentive to violate the antitrust laws. A company would know that there would be no tax penalty for such violation, even when divestiture was ordered. Since there would be no penalty, what incentive would there be for any corporation to carry out either the spirit or the letter of the law?

If some different treatment is felt to be necessary in cases of divestiture under the antitrust laws than now exists, it would seem that paying at the capital gains rate of 25 percent would be more appropriate than any other method of treatment. This would yield close to $700 million.

Tax relief of the enormous amounts contemplated is against the public interest. Never have such enormous amounts been given by so many to so few.

IMPORT TAX ON LEAD AND ZINC (SEC. 15)

Section 15 of the subject bill contains the substance of the bill S. 3698 which was introduced on June 18, 1960. There have been no public hearings on this bill and, in our opinion, no adequate study by the Finance Committee.

Similar bills have been introduced in the past and, in fact, approved by the Finance Committee. In this connection, we would call attention to our minority views contained in Senate Report 1053, 85th Congress, 1st session. We consider those views to be still valid.

Section 15 represents an attempt to undermine our reciprocal trade program and a return to logrolling on tariffs. It may well harm our entire domestic economy without furthering our foreign policy objectives or providing effective aid to this particular industry. This section would impose a fixed duty on lead and zinc with a flexible additional tax to be applied when the domestic prices of these commodities fall below specified levels. The duty is quite large as compared with the present price of these commodities and would signal a return to a protective tariff.

We should never forget that the last increase in the protective tariff; namely, the Smoot-Hawley Act of 1930, directly stimulated reprisals all over the world. This further shrank the volume of world trade and among other consequences stimulated the Empire Preference Agreements within the British Empire. It distinctly increased economic nationalism and intensified the world depression.

If the present proposal is enacted, and similar proposals follow, they would invite and in all probability would have similar bad effects.

Adoption of this proposal would be a major reversal of the Cordell Hull reciprocal trade policy. It is well known that the tariff issue has in the past given rise to some of the worst abuses in our legislative history.

By the establishment of the Tariff Commission and the reciprocal trade program, Congress put our trade and tariff policy upon a sounder footing. Under the program of Cordell Hull we moved toward greater world trade, to the advantage of our own as well as of other countries. Then to protect American industry from temporary and localized losses, we set up the procedures of the so-called peril-point and escape clause. This transferred to the President and to the Tariff Commission the vexatious task of dealing with the claims to protection of a wide variety of industries.

Despite the decrease in domestic production, the United States remains the world's leading consumer of lead and zinc.

The preservation of the lead and zinc mining industry is important. It is important to those who are engaged in this industry, both those who invest their capital and those who invest their labor. It is also important for national strategic reasons.

Higher U.S. tariffs on lead and zinc will directly operate to decrease our exports to the four countries from which we import most of our lead and zinc, namely, Canada, Mexico, Peru, and Australia. Since the amount of goods which these four countries can sell to us will be appreciably reduced, this will automatically reduce the amounts which they can buy from us. International trade is ultimately a process of balance in barter, in which the goods and services of a given country such as ours are exchanged for the goods and services of other countries. These countries cannot buy from us unless they can sell to us and when we cut our purchases from them, they will have to cut theirs from us.

As for national strategic considerations, it would appear that the United States is in a favorable position. Several programs have been undertaken in recent years toward this end. Lead and zinc have been stockpiled through a Government purchase program and direct subsidies have been granted for exploration and development work.

The Federal Government has not been oblivious to the needs and difficulties of the domestic lead and zinc mining industry. Several programs have been undertaken to assist the industry. Exploration grants as of December 31, 1959, had amounted to $6,129,000 for lead-zinc and $3,823,000 for lead-zinc-copper, or a total of almost $10 million. Numerous companies have had their explorations certified as discoveries as a result of this program. The Government has also, under the Defense Production Act of 1950, authorized loans to increase the production of lead and zinc.

In addition to the above programs for the direct and specific benefit of the lead and zinc mining industry, the companies operating in this field also have available the tax deductions for exploration and development, in addition to percentage depletion allowances. The percentage depletion allowance in the Internal Revenue Code of 1954 was increased to 23 percent for production within the United States but the old 15-percent level for operations outside the United States was retained.

In considering a program designed to benefit lead and zinc mining, we must keep in mind not only domestic economic and national strategic considerations, but foreign policy objectives as well.

As we have pointed out, the United States is the world's largest consumer and importer of lead and zinc. Most of the lead which enters international trade is mined in Australia, Mexico, Canada, Peru, Morocco, the Union of South Africa, and Yugoslavia. Most of the zinc ore which enters international trade is mined in Canada, Australia, Mexico, Peru, the Belgian Congo, and Italy. Cooperation with most of these countries in economic matters is a part of overall U.S. foreign policy. The type of unilateral action represented by this section will adversely affect the economy of some of these countries and will run counter to other programs which the Government of the United States is fostering in these countries.

It might also be pointed out here that, as in so many other instances, efforts to cure the problems faced by the lead and zinc mining industry in the United States cannot be considered in isolation. In most of the foreign countries listed above as furnishing lead or zinc for international trade, a large part of the ore is produced by concerns in which U. S. mining or smelting and refining companies have a substantial financial interest. During this session of the Congress, the Senate has approved the bill, H.R. 10087, which liberalizes provisions of law relating to the foreign tax credit and thus acts as an inducement to further U.S. investment abroad in the extractive industries where the branch, rather than the subsidiary, is the customary form of organization. Section 15 of the subject bill now works at cross purposes by attempting to destroy a part of the market for these foreign mines. The upshot of both these actions taken together, however, will be an increased burden on the American consumer, with lead and zinc producers, foreign and domestic alike, taking advantage of the additional, artificially induced profits.

The worldwide imbalance between production and consumption of lead and zinc in recent years is a worldwide problem. It cannot be solved by unilateral action by the United States. Efforts are being made, however, to solve this problem. Several meetings have already been held under the auspices of the United Nations. Meetings were held in London in September 1958, in Geneva in November 1958, in New York in April and May 1959, and again in Geneva early this year.

At the November 1958 meeting, it was agreed that this problem should be treated as a matter of urgency. At the May 1959 meeting, several representatives of governments and private companies announced cuts in production and export of lead and zinc. At the meeting held in Geneva early this year, several lead producers offered to reduce the amounts of lead they would market and it was expected that the estimated lead surplus would be cut in half during the first 9 months of 1960. Another meeting is to be held early in September of this year.

To sum up, we do not feel that such a direct attack on the Cordell Hull reciprocal trade program as the one embodied in section 15 of this bill should be enacted by the Congress, and certainly not without thorough study. Should the solution to the domestic lead and zinc problem be sought along the lines proposed, the artificially high and rigid price levels induced thereby may well be hurtful to the whole economy and, indeed, may result in the widespread use of substitutes for lead and zinc, thereby dealing a death blow to domestic mining of these minerals. Seeking a solution to the world problem of imbalance between production and consumption of lead and zinc by unilateral U.S. action of the type outlined in section 15 of this bill will not further our foreign policy objectives.

The provisions of this section would signify a return to the legislative determination of tariff schedules. We predict that it will open up the floodgates and that a host of other increases will be proposed. For if the tariffs on lead and zinc are skyrocketed by special legislation, then we can expect that the producers of textiles, copper, and a myriad of other products, metallic, manufactured, and agricultural, will demand and quite possibly obtain similar favors. We will indeed have opened Pandora's box.

In the process, the reciprocal trade program will go down the drain. The painful efforts to bind the free world closer together economically will be defeated and the world will tend to relapse into economic nationalism.

We do not believe that the people of this country want this. We are convinced that it would be against the longrun best interests of the United States. Section 15 should be stricken from the bill.

PAUL H. DOUGLAS.
ALBERT GORE.

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