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INTERNAL REVENUE

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

SIXTY-SEVENTH CONGRESS

FIRST SESSION

ON

H. R. 8245

AN ACT TO REDUCE AND EQUALIZE TAXATION, TO AMEND AND SIMPLIFY THE REVENUE ACT OF 1918, AND FOR OTHER PURPOSES

SATURDAY, OCTOBER 8, 1921

PART 2

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INTERNAL REVENUE.

SATURDAY, OCTOBER 8, 1921.

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

The committee met in executive session, pursuant to call of the chairman, at 10.30 o'clock a. m., in room 312, Senate Office Building, Hon. Boies Penrose presiding.

Present: Senators Penrose (chairman), McCumber, Smoot, La Follette, Dillingham, McLean, Curtis, Watson, and Sutherland.

Present, also: Dr. T. S. Adams, tax adviser, Treasury Department; Mr. John E. Walker, Chief Legislative Drafting Service of the United States Senate; Middleton Beaman, Chief Legislative Drafting Service, House of Representatives; and Mr. J. S. McCoy, actuary, Treasury Department.

The CHAIRMAN. Mr. McCoy will continue his explanation or comparative rates in relation to preceding schedules and as now pending before the committee suggested and proposed by certain Senators.

Senator DILLINGHAM. I did not get from you the $100,000 income tax under the proposal of the "bloc."

STATEMENT OF J. S. McCOY, ACTUARY, TREASURY DEPARTMENT.

Mr. McCOY. $22,460.

Senator DILLINGHAM. And how much would it be under the Senate amendment?

Mr. McCOY. $20,780. You get $50,000,000 more income for this year under this bill—that is, for the year 1922—than you would under the Senate committee bill.

Senator WATSON. How much more do you raise the surtaxes following the $200,000 by the proposed plan than under the Senate bill? Show the difference in those lower surtaxes?

Mr. McCOY. Up to $100,000 there is not very much difference; the principal gain is over the $100,000.

Senator WATSON. Between a $100,000 income and $200,000 is the same gain?

Mr. McCOY. All the way up, from about $80,000. Incomes over $80,000 will pay more tax; under that they will pay less tax until you get in the lower brackets, where the percentages will be considerably less.

Senator MCCUMBER. In other words, if a man has an income of $100,000 he pays $58,000 to the United States and $12,000 more, we will say, if he lives in New York or Wisconsin, which he will pay to the State government, which would make $70,000, which would leave him $30,000.

The CHAIRMAN. There is the poll tax, and so on.

Senator MCCUMBER. But those are deducted from the net.

Mr. McCOY. $70,960 of surtax, and added to that will be the normal tax.

The CHAIRMAN. The committee will now return to the examination of Dr. Adams concerning some pending amendments.

STATEMENT OF DR. T. S. ADAMS, TAX ADVISER, TREASURY DEPARTMENT—Resumed.

Dr. ADAMS. On the printed statement the amendments Nos. 3 and 4——

Senator WATSON (interposing). Where do all these proposed amendments come from? Are they your own suggestions?

Dr. ADAMS. Most of them. Some of them came from various Senators, covering things they want to be inserted.

Senator WATSON. Some of them have been approved by the committee.

The CHAIRMAN. Do these amendments, Dr. Adams, include all those offered in the Senate by Senators?

Dr. ADAMS. Not all of them. Nos. 3, 4, and 5 relate to the net-loss provision. The net-loss provision is based upon what might be called an economic definition of the net loss. A man has got to have a real net loss rather than a statutory net loss before you allow it. For instance, you insist that he include in his income for the purpose of computing this loss such an item as interest from tax-free securities.

It is provided in the present bill that the tax-free income shall be counted in before the net loss is computed, but certain bankers have called attention to this, that they are denied the deduction for interest on money borrowed to purchase and carry tax-free securities. They say, "If you are inserting or including the income from tax-free securities for this purpose, you should similarly allow the deduction for interest paid to carry those securities." Those two things equitably go together. We have put only one of them in—the interest received. We should deduct the interest paid. That seems to be fair.

Senator MCCUMBER. We have abolished that principle for the next year?

Dr. ADAMS. No; not that particular principle. You put into the gross income—that is the practical result of it—tax-free interest received, for the purpose of computing this net loss. Now, suppose that a man has been denied deduction for interest actually paid to hold and carry tax-free securities. They insist that we should allow the interest deduction merely for the purpose of computing this net loss; in other words, they insist that both interest received and interest paid shall be taken into account. I think they are right.

Senator SMOOT. Take a particular case. If you have $10,000 worth of tax-free Government bonds, under existing law you do not pay any tax upon them whatever?

Dr. ADAMS. Not upon the interest; it is not even included in the income.

Senator SMOOT. Do I understand if this amendment is adopted that if you have a loss that loss can not be allowed if it is less than the interest paid upon tax-exempt bonds?

Dr. ADAMS. Suppose a taxpayer is getting $5,000 interest from municipal bonds. Suppose that taxpayer's income-tax return shows a loss—that is, his deductions exceed his income by $3,000. We say, "You have not had, for purposes of this special net-loss allowance, any true net loss, because you had $5,000 interest which you did not put in your gross income." So we would ignore that net loss. He merely had a statutory loss.

Senator SMOOT. Supposing the taxpayer has $5,000 income from tax-exempt securities and his gains have been $15,000, but his losses have been $16,000. Is that man taxed?

Dr. ADAMS. Oh, no; he is not taxed; we are not proposing to tax him. But his income-tax return would show a loss of $1,000. Now, then, you are making a special allowance in your net-loss provision, and he is permitted to carry a loss forward to the next year. But this special allowance only applies when the taxpayer has sustained a net loss over and above all receipts or income, including interest from tax-exempt bonds. There has got to be a true economic loss before you allow it to be carried into the next year.

Senator SMOOT. So far as taxation is concerned, there was a true loss. But of course this man's tax-exempt securities shall not be allowed to offset a loss in business or from any source taxable that could be carried on to another year.

Dr. ADAMS. Senator, this is an amendment suggested by your friend, Mr. Reed. The present bill provides that in computing a net loss the taxpayer must put in his tax-free interest; he has got to have a loss over and above that, counting that as income.

Senator SMOOT. I do not know but what it is fair; but I was getting at what change it was going to make, and it seems to me that under existing law a man who had a gain of $15,000 and a loss of $16,000, although he had $5,000 income from tax-free securities, he would be allowed that $1,000 loss.

Dr. ADAMS. That was not permitted in the net-loss provision of the present law, and it has not been done here.

Senator MCCUMBER. Are you not taxing your tax-free securities?

Dr. ADAMS. We are not taxing them at all.

Senator McCUMBER. Let us see whether you are not. Suppose a man has an income of $5,000 from municipal bonds, which are tax free. He is engaged in business in addition to that, and in his business proposition he loses $2,000. You say that he has not had a real loss because he got $5,000 from the other source, and therefore he has really had a net gain in that year of $3,000. Do you tax that $3,000?

Dr. ADAMS. No; not at all.

Senator McCUMBER. You will not tax it, but at the same time you will give him no benefit of a loss in his business to be taxed as against a gain in his business.

Dr. ADAMS. That is another question.

Senator LA FOLLETTE. If you make this proposed change, it operates as an encouragement to invest in tax-free securities?

Dr. ADAMS. No; it hardly amounts to encouragement.

Senator LA FOLLETTE. If you make this proposed change, you are encouraging investment in tax-free securities?

Dr. ADAMS. I was going to suggest to you that you go a little further and provide this: Take the $5,000 tax-free interest in question, and say that instead of putting it all in the income you put only so much as the $5,000 tax-free interest exceeds the interest which the taxpayer paid on indebtedness contracted to purchase or carry the tax-free bonds—give him credit for interest paid if it does not exceed tax-free interest received.

Senator WATSON. If he borrowed money to buy the municipal bonds?

Dr. ADAMS. If he borrowed money to buy municipal bonds, and pays interest on it which he is not now allowed to deduct, permit him to deduct the interest paid up to the amount of tax-free interest received which he is required to treat as a receipt for this purpose.

Senator McCUMBER. The whole trouble lies in making any return upon tax-free incomes. There is no reason on earth for putting that in and then subtracting from something else.

Dr. ADAMS. You do not return such interest under the new law, except in this case where you have a net loss.

Senator McCUMBER. If you can not deduct the business loss from the next year, the whole of it, the effect of it is that you are taxing tax-free income, or income from the interest on tax-free bonds. The effect is that in the next year you can not deduct the business loss of this year clear up to the full amount of that business loss.

Dr. ADAMS. This whole net-loss business appeared foreign and strange, and seemed such an unusual privilege to the taxpayer, when it was first put forward, that the committee thought at the time it ought to be safeguarded in every way.

While I think this amendment is just, I also think there is no reason in the world why a man who has in his net operations for the year an actual gain, which gain is represented partly by interest from tax-free securities, should be permitted to charge against income for the next year a loss which actually he did not sustain.

Senator McCUMBER. That would be a reason against allowing one year's loss to be deducted from the next year's gain. But the point I want to make, and make as clear as I know how to make it, is that if a person has an income of $5,000 from tax-free securities and has a loss in the same year from his business of $2,000, and in the next year he has a gain from business of $10,000, if you do not allow him to deduct the entire loss that he had this year, or if you simply deduct a portion of it, which would be the difference between what he got from tax-free income and from his business, you are necessarily taxing next year the tax-free interest. It comes down, as I see it, to a matter of policy. Do you want to allow privileges and deductions which you are not compelled by the Constitution to allow? That is a question for you gentlemen and not for me. I question the attitude toward tax-free interest on tax-free bonds.

Senator SMOOT. I can not see but what it does tax that portion of the tax-exempt income providing there is a loss.

Senator McCUMBER. By putting a heavier tax on the income next year.

Mr. BEAMAN. You are not speaking of the constitutionality of that?

Senator McCUMBER. Oh, no; I am not speaking of the constitutionality of it, although I think if you always offset one year's loss against another year's gain, then if you apply this law I think it would be unconstitutional.

Mr. BEAMAN. The Congress is not obliged to allow the net loss to be deducted next year; they are doing that as a favor, and they can guard it with such restrictions as they please.

Senator McCUMBER. You would have a different law for different people if you would now apply it just as you have written it.

Dr. Adams, have we not provided that after the year 1921 there shall be no allowance for interest on borrowed money to buy Liberty bonds?

Dr. ADAMS. Yes; that is true. There is not much of an allowance now. The only allowance given now is the allowance for money borrowed to carry Victory 3¾s; that is about all. In carrying State exempts, municipal exempts, and 3½ exempts they are denied the privilege of deducting interest on indebtedness incurred to carry such bonds.

Senator McCUMBER. Why should we not eliminate the necessity entirely of returning the income from tax-free securities as a part of your gross income and then deducting something else from it?

Dr. ADAMS. You have done that, Senator, in the ordinary return where no net loss is claimed. But the net-loss privilege is a special, unusual allowance. It is not allowed in the income-tax law of any other country that I know of, in just that form. But we say there must be a loss over and above all income received. It was that way in the net-loss provision of the 1918 act; it was so in the House bill; it has been in the Senate bill all along. But now a man comes and says, "That is not quite fair. You have barred me from deducting some interest which we actually have to pay. I should be allowed to deduct that." That appeals to me as a sound proposal. But do you want to go further than that?

Senator McCUMBER. I want to eliminate both of them.

Mr. BEAMAN. You want to change the present bill?

Dr. ADAMS. You want to change the present bill, and take no cognizance of the tax-free income. I am quite content to accept anything you do in the matter.

Mr. BEAMAN. And no cognizance of interest on money borrowed to buy it, because any taxpayer can borrow $100,000, if he holds that many bonds, and use that money in his business, and yet make his books show that it is borrowed to carry tax-free bonds, and use the interest as a deduction.

The CHAIRMAN. Information has been brought to the committee that you are not satisfied with amendment No. 1 that the committee has agreed on.

Senator KELLOGG. I am not; I do not think it ought to be adopted.

The CHAIRMAN. Then you desire to open the question on the floor?

Senator KELLOGG. I do; if that amendment is adopted.

The CHAIRMAN. If you are going to make a fight, the committee do not think they would be accomplishing anything by trying to help you.

Senator KELLOGG. I would rather agree to it than have the committee take the original Senate provision.

The CHAIRMAN. Then if the committee holds on to this compromise——

Senator KELLOGG. I should not fight it.

The CHAIRMAN. If there is no objection, that is agreed to.

Dr. ADAMS. We now come to No. 2.

The CHAIRMAN. If there is no objection, No. 2 is agreed to.

Senator SUTHERLAND. I move that No. 3 be adopted.

(The committee voted not to agree to the amendment.)

The CHAIRMAN. The next if No. 4.

Dr. ADAMS. In respect to No. 4, you will recall that only business losses are deductible; but here, again, in order to protect the Government, the provision has always been that nonbusiness income should go in. Nonbusiness income goes in automatically. The same gentlemen who raised the other question raise the point—which I think is similarly a just claim—that if nonbusiness income goes in, we ought to allow nonbusiness losses also to the extent covered by business gains. Suppose a man has invested in business and that he sustains a business loss of $10,000. But suppose he has a nonbusiness income or gain from some collateral transaction——

Senator SMOOT (interposing). For example, a stock-exchange transaction?

Dr. ADAMS. A stock-exchange transaction of $1,000. By existing law that $1,000 is already in his income and would reduce his net loss to $9,000. But suppose that man also had a nonbusiness loss; that is ruled out. This proposal is that that nonbusiness loss be allowed to the extent that he has nonbusiness gains.

Senator McCUMBER. The reason we did not allow that in the past was that a man wanted everything he made in gambling but did not want to take the gambler's loss.

Dr. ADAMS. It takes it this far: A man has a business loss, and then in addition to that some nonbusiness gains and losses; the proposal is to allow the nonbuiness losses to the extent of the nonbusiness gains.

Senator McCUMBER. Suppose a man makes $10,000 in his mercantile business. Maybe he has a real estate mortgage which proves to be worthless, of $1,000, and there is a loss, but he makes a gain in the sale of some bonds of $2,000. Under the law as it now stands, or as we have amended it, would you deduct his $1,000 loss from the $2,000 gain, it being entirely a different character of transaction?

Dr. ADAMS. Take an illustration which shows not a gain, but a loss. He has a nonbusiness gain of $2,000, you said, and also a $1,000 nonbusiness loss?

Senator McCUMBER. Yes.

Dr. ADAMS. Under the existing net-loss provision we would subtract the $2,000 from the $10,000 net loss and make it only $8,000 net loss, and we would ignore the nonbusiness loss. It is proposed to modify that to this extent: You would start with the $10,000 business loss and then reduce it by the excess of his nonbusiness gains over his nonbusiness losses.

Senator WATSON. It is reduced by $1,000 instead of $2,000?

Dr. ADAMS. Yes.

Senator SMOOT. He would have to pay tax upon $2,000 gain.

Dr. ADAMS. There would be no tax on him in any event.

Senator SMOOT. If it goes on next year, the same principle exactly, with the exception one is tax exempt and the other is from a business?

Dr. ADAMS. The Senator is right. A moment ago we had nontaxable interest received against which it was proposed to set interest paid.

Senator McCUMBER. Why the necessity of all this complexity? Why not compel him to put into his income his net income from every source?

Dr. ADAMS. It is done.

Senator McCUMBER. And deduct his loss from every source?

Dr. ADAMS. That is the question.

Senator McCUMBER. Why do we want anything of this character in it? You say "every source." What is the use of going into the particulars of the source?

Dr. ADAMS. I have simply adopted, or adapted, the net-loss provision of existing law. When this net-loss provision was first put forward it was with the utmost difficulty that the committees of Congress could be got to listen to or accept it. They insisted upon confining this allowance to business losses. It was deliberately decided not to give the allowance to mere investors or to persons sustaining losses from the burning or destruction of automobiles and the like. You wanted to confine it to the business concern. In doing that the nonbusiness gains got in, but the nonbusiness losses did not get in.

The CHAIRMAN. If there is no objection, the amendment will not be agreed to. The next is No. 5.

Dr. ADAMS. Amendment No. 5 works the other way. You will recall the recent decision of the Supreme Court in the so-called "Woodward" case, which has been discussed on the floor and the decision published a few days ago in the record. It was decided that an estate in computing its income might take deduction for any estate or inheritance tax paid to the Federal Government.

I think the decision will also cover State inheritances, too.

Suppose an estate has a good, round income, but pays a large Federal estate tax. It will get a net loss based on the estate tax paid. Do you or do you not want that kind of loss to be carried forward and be treated as a net loss in subsequent years? Your present proposed bill would treat a net loss resulting from the payment of a heavy Federal estate tax as a net loss to be absorbed from the income of the estate for the next year, if it had any income. The proposed amendment would bar that. Which do you want?

Senator SMOOT. If it is right to give exemption from taxation, it does seem right that it should be carried on to the next year, if there is a loss within the first year.

The CHAIRMAN. Do you recommend that, Dr. Adams?

Senator LA FOLLETTE. What would be the effect on the revenue?

Dr. ADAMS. There will be only a few cases, but they will be very important cases. The estate tax is really a capital transaction, a reduction of capital. There has been grave doubt about this deduction. The Supreme Court held that the language of the statute permitted the deduction, and no change has been made in that.

Senator McCUMBER. Permitted it because the statute in describing the thing that should not be deducted did not include estate taxes?

Dr. ADAMS. And its affirmative language was sweeping—all taxes except income and profit taxes.

Senator McCUMBER. We have not changed that?

Dr. ADAMS. No.

Senator McCUMBER. Our reason for not changing it was that we concluded it was hardly a tax, but the taking of a portion of the estate itself.

Dr. ADAMS. That would be an argument, I think, for not allowing the estate tax to be treated as deduction. But on that point the law stands just as it has been in the past.

But suppose the estate tax is three or four times the income of the estate for that year. Let us suppose the income is $350,000 and the estate tax $500,000. That will give them a net loss of $150,000 to be carried forward two more years, to be deducted from the income of the estate for the next couple of years. Do you wish a net loss to be created by the payment of an estate tax or do you think that particular variety of loss should be barred?

Senator LA FOLLETTE. What would be approximately the loss in revenue?

Dr. ADAMS. Senator, I can not approximate it. There are probably estates that have income taxes of a million dollars, perhaps, and this may be wiped out for a couple of years by a net loss created by payment of estate tax. The loss can not be very large, but it may possibly be a million or two million dollars a year.

Senator SMOOT. This would only apply for two years?

Dr. ADAMS. Only for two years in any one case. But the same thing would happen once with every large estate. For three years, instead of one year under existing law, its income would likely be wiped out by the estate and inheritance tax which it pays. If you adopt this amendment, you will prevent that.

Senator SMOOT. I move to disagree to amendment No. 5.

The CHAIRMAN. If there is no objection, No. 5 will be disagreed to. We now come to No. 6.

Dr. ADAMS. No. 6 is a provision you agreed to at the last meeting.

The CHAIRMAN. That has been agreed to. Now we will take up No. 7.

Dr. ADAMS. No. 7 is rather an important amendment dealing with the present deduction for interest paid on indebtedness contracted to carry tax-free securities. I think you better turn to that, and we will go over the language. It is found at page 38 of the bill, lines 9 and 10 [reading]:

"All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities, the interest upon which is wholly exempt from taxation under this title as income to the taxpayer."

The language in question is "as income to the taxpayer." Does this provision mean that the taxpayer can not deduct interest paid on indebtedness incurred to carry Liberty bonds simply because he individually is not taxable? Or does it mean that you can deduct interest paid on indebtedness contracted to carry Liberty bonds because in general they are or may be taxable under this title?

Senator WATSON. Give us an illustration.

Dr. ADAMS. Suppose I borrow money in order to buy $4,000 worth of Liberty bonds. I am not taxable on interest from that amount under any circumstances. Then can I deduct the interest which I pay on the debt contracted to buy and carry those Liberty bonds? That is a nice question. The interest from such Liberty bonds is theoretically subject to tax under this title. It is not in my own particular case subject to tax under this title. There is a very nice question of construction here.

The CHAIRMAN. Dr. Adams, is not the department making rulings on these things?

Dr. ADAMS. The department feels that it would like to have your decision about the matter.

Senator CURTIS. The only thing left out is income to the "taxpayer."

Dr. ADAMS. This is one of the questions which worried Senator Hitchcock on the floor. People say, "I own only $50,000 of Liberty bonds and am not subject to tax on that amount. Am I therefore denied the right to deduct the interest on indebtedness incurred to carry that?"

Senator WATSON. What is your construction?

Dr. ADAMS. My construction is that the word "title" is controlling.

Senator SMOOT. I thought this was an amendment giving notice that after the taxable year 1921–22 interest would not be allowed.

Dr. ADAMS. That is correct, but this doubt still remains.

Senator SMOOT. But they ought to be given that year's notice.

Dr. ADAMS. This amendment does not disturb or touch that.

Senator SMOOT. The only thing I see in that, Dr. Adams, is this: A man may borrow money to buy these Liberty bonds, but in the course of his business he may have sufficient money to take up all of the other loans that he was carrying in his own business. But the interest coming from the Liberty bonds he would claim exemption for, and that would be the last interest he would pay, or last obligation on those Liberty bonds, and perhaps the money would be used in his regular business, and I do not see how you can separate or find out whether it was used in his business or whether it was used to pay interest on those Liberty bonds.

The CHAIRMAN. Mr. Walker has called by attention to a letter which I received from John Wanamaker, in which he says he is carrying Liberty bonds at a very great loss on borrowed money, to the extent of several hundred thousand dollars a year.

Dr. ADAMS. Which he had to take back from employees because he encouraged them to buy the bonds.

The CHAIRMAN. This is rather a notable case of an individual, and that is the reason I brought it to your attention.

Senator SMOOT. Why not leave it the way it is now, with the notice given in that amendment beginning on line 13 down to and including line 19?

Dr. ADAMS. I do not object to that; but you ought to know that the Treasury Department is going to rule, under the present language, and is practically committed to rule, that the present law means what the proposed amendment explicitly states.

The CHAIRMAN. You are talking of No. 7?

Dr. ADAMS. Yes.

The CHAIRMAN. I think we ought to agree to No. 7; and if there is no objection, it will be considered agreed to.

Dr. ADAMS. No. 8 covers a small point, but it is important. It states when an estate tax accrues and fixes the date. [Reading:]

"For the purpose of this paragraph, estate, inheritance, legacy, and succession taxes accrue on the due date thereof, except as otherwise provided by the law of the jurisdiction imposing such taxes."

The CHAIRMAN. Is there any objection to that amendment? If not, it is agreed to.

Dr. ADAMS. No. 9 is that little business putting "before or" in case you buy securities of the identical kind, and has been adopted already.

The CHAIRMAN. That is agreed to.

Dr. ADAMS. No. 10 relates to that same question of buying back the same stock that you sold. The statute now uses the word "identical." It has been suggested from many quarters that unless you wish to make that very rigid you had better put in "substantially" identical.

The CHAIRMAN. That is agreed to.

Dr. ADAMS. No. 11 deals with amortization, and is an important amendment. It provides that no new amortization shall be allowed; in other words, that while plenty of time shall be given to adjust existing amortization claims the taxpayer can not bring in new amortization claims that were not entered in the returns for 1918 or 1919.

Senator SMOOT. I move that that be agreed to.

The CHAIRMAN. If there is no objection, the amendment, simply carrying out what is in the bill now, is agreed to.

Dr. ADAMS. No. 12, that is a verbal addition to remove uncertainty. I thought you had done that before, but I am told there is a slight doubt.

The CHAIRMAN. If there is no objection, it is agreed to.

Dr. ADAMS. Amendment No. 13: Page 63, line 19, that is an amendment you have already adopted, striking out "irrevocable" in connection with stock purchases.

The CHAIRMAN. That is agreed to.

Dr. ADAMS. Amendment No. 14: That is purely verbal. It substitutes for "at the same time" the words "upon the same basis." You can not always make the assessment at the same time.

The CHAIRMAN. If there is no objection, that is agreed to.

Dr. ADAMS. Amendment No. 15: Page 75, line 15—largely verbal. The same rule which is given for returns when the accounting periods change should be extended for all returns for a period of less than 12 months. It prorates

the specific credit, gentlemen, when a corporation makes a return for less than a year.

Senator WATSON. I move that it be adopted.

The CHAIRMAN. It is moved that it be adopted; and if there is no objection, it is agreed to.

Dr. ADAMS. The same thing is involved in amendment 17, which actually does it in the text; in other words, the explanation I just gave was really applicable to 16, and 15 was the new heading to precede this section as amended.

The CHAIRMAN. Without objection, that is agreed to.

Dr. ADAMS. No. 17, page 80, line 1, relates to domestic building and loan associations, and is rather an important matter. You gentlemen adopted an amendment limiting the exemption of building and loan associations to building and loan associations substantially all the business of which is confined to making loans to members. It was stated on the floor of the Senate that companies could easily get around that by simply making everyone who wants to borrow pay 25 cents to become a member. I do not know whether you wish to limit this exemption, but if you do, do it with language that is not easy to evade. You can accomplish that by inserting after the word "members" the words "on the basis of their stockholdings."

However, that is pretty strenuous, and I want to warn you that it is going to deny the exemption to many alleged building and loan associations. If you want to put teeth into that limitation, I think that is the way to do it.

Let us read the exemption. The present language in the bill is [reading]:

"Domestic building and loan associations substantially all the business of which is confined to making loans to members."

The statement is made that mere loan companies can secure this exemption by making every borrower in form a member. The question is, What can you do to establish a real limitation? I asked the question of the men in the office who are familiar with the matter, and they say if you really want to put teeth in this limitation, put it on the basis of stockholdings.

The CHAIRMAN. That is not the practice now?

Dr. ADAMS. The door is pretty wide open.

Senator SMOOT. This is to conform with the original idea of the building and loan association.

Senator WATSON. I move that it be adopted.

(Agreed to.)

Dr. ADAMS. The next amendment is verbal, simply to remove a slight doubt. Page 82, at the end of line 22, add a new sentence as follows [reading]:

"In the case of a foreign corporation or foreign trade corporation the computation shall also be made in the manner provided in section 217."

I always assumed that would be done. Mr. Beaman thinks we better state so explicitly.

Senator CURTIS. I move that it be agreed to.

(It was agreed to.)

Dr. ADAMS. Amendment No. 19, page 83, lines 16 and 17, is purely technical. Mr. Beaman thinks it is much better, instead of saying that a certain action shall be taken under the provisions of a certain section, that it shall be done "in the manner provided in."

Senator MCLEAN. I move that it be adopted.

(The motion was agreed to.)

Dr. ADAMS. Amendment No. 20 applies the same rule to corporations that you have agreed to in the case of individuals. This is that interest proposition.

(Agreed to.)

Dr. ADAMS. The next one goes out. You did not agree to this.

The CHAIRMAN. 22, 23, and 24?

Dr. ADAMS. 22, 23, and 24 are provisions you have agreed to in the case of individuals. They follow naturally in the case of corporations.

Amendment 25, page 98, after line 14. This is an amendment in which Senator Kellogg was specially interested. It was really omitted by inadvertence. He has introduced it and will talk about it on the floor. It has to do with credits for foreign taxes. If an American concern pays foreign income or profits taxes abroad, you give a credit for it.

There arises the case of an American corporation owning all the stock of a foreign subsidiary. Suppose the foreign subsidiary makes money, pays a foreign tax, and sends back all or part of the profits as dividends to this country. That is a good deal like taxing the profits of that foreign subsidiary, and

under the 1918 law, subdivision (c) of section 240, a provision was inserted giving the American parent company a deduction for the foreign taxes paid by the foreign subsidiary or a proper share thereof, because the dividends, of course, might not represent all the profits of the foreign subsidiary.

Now, the House bill exempted dividends from taxation altogether, so there was no necessity for this credit. Therefore this provision was omitted from the Senate bill. At a late date, however, you adopted a provision taxing dividends received from foreign corporations, whereupon this question again becomes of importance. I rewrote the old provision, safeguarding it from some abuses which it was open to and closing up some of the gaps that were in the old provision. While Senator Kellogg will take the matter up on the floor, it would be a little better, if you want to accept it, that it be approved here, because we have changed the letters of certain other subdivisions—put this amendment in as subdivision (e), where it properly belongs, while he simply tacks it on at the end of the section. This is the better form.

It would do this: In case an American corporation owns a majority of the voting stock of a foreign subsidiary and gets dividends from that subsidiary, the American corporation would be permitted to use as a credit a proper share of the foreign income and excess-profits taxes paid by the foreign subsidiary. That is only true in case the dividends are taxable. It is safeguarded, for the first time, by providing that the domestic corporation can not take a credit which exceeds that proportion of its total tax which the amount of dividends received bears to the total taxable net income of the domestic corporation.

Senator WATSON., What does that mean?

Dr. ADAMS. It is perhaps the most intricate provision in the tax law. Suppose an American corporation owns a branch in Paris, a branch of the American corporation. All of the income of that branch would be included in the income of the American corporation. But after that was done, the American corporation would be entitled to credit against our tax the tax which its branch paid in France. That is the starting point.

Senator SUTHERLAND. If equal, it would be wiped out entirely?

Dr. ADAMS. Yes. Then, let us come back to another situation which legally is different, but economically and practically is much the same. The American corporation does not own the branch in France, but the branch has been incorporated under French law, and the American corporation owns the stock. Then suppose that subsidiary corporation——

Senator SUTHERLAND (interposing). Or a majority?

Dr. ADAMS. Or a majority; and the majority of the voting stock controls it. Suppose the branch corporation pays French taxes; but after having paid those taxes it sends a large dividend back to the American corporation. That dividend may be taxable to the American corporation.

Senator SUTHERLAND. To the amount of its stock holdings?

Dr. ADAMS. The American corporation is taxed on that as part of its net income. Without special provision, it would get no credit for the foreign tax. The proposal is to give this American corporation about the same credit as if conducting a branch, and the situation is this——

Senator SUTHERLAND (interposing). Dividends received on its stock ownership in that corporation?

Dr. ADAMS. Yes.

Senator SMOOT. Suppose a foreign corporation makes a loss, are they also entitled to deduction?

Dr. ADAMS. No.

Senator SMOOT. Or, is the deduction made upon their gains?

Dr. ADAMS. Upon their gains.

Senator Kellogg will offer this, but here is the whole point: Senator Kellogg will offer it as subdivision (f) of section 238. It really ought to be offered as subdivision (e); (e) should be numbered (f).

The CHAIRMAN. That can be corrected.

Is it the pleasure of the committee that that be omitted from the bill and that the chair be authorized to accept it if Senator Kellogg presses it on the floor, after a full explanation? If there is no objection, that will be the sense of the committee.

No. 26 has already been corrected. The next is No. 27.

Dr. ADAMS. No. 27 has been agreed to.

The CHAIRMAN. That is agreed to. No. 28.

Dr. ADAMS. No. 28, gentlemen, is a question of substance. The life insurance company amendment as it now stands imposes on life insurance companies for the year 1921 a tax rate of 15 per cent. This amendment would give the life insurance companies a tax rate of 10 per cent for the year 1921, and it does it in this way: In place of the 15 per cent rate the House bill fixes the rate of 12½ per cent. You would strike that out and say in lieu of that that the rate applicable to life insurance companies shall be the same percentage of net income as is imposed on other corporations by section 230. That would be 10 per cent for this year and 15 per cent hereafter.

Senator MCLEAN. They have paid their tax on their premiums this year.

Dr. ADAMS. That is right.

Senator MCLEAN. And this will amount to more than other corporations will have to pay. I move we agree to the amendment.

Senator SUTHERLAND. Is No. 28 agreed to?

Dr. ADAMS. I understood so.

Senator SMOOT. The same with No. 29.

Dr. ADAMS. No. 30 is a proposal to give to life insurance companies which pay taxes for their shareholders the same deduction which you have given to banks and other corporations.

Senator SMOOT. I do not think that has been agreed to.

Senator MCLEAN. Why should they not have the same?

Dr. ADAMS. I believe you thought you were doing it when you adopted a similar amendment to section 234 (a) (8). The thing that was given to banks and to all other corporations, and I told Senator McLean we had done so; but it seems that by adopting special insurance provisions you leave some doubt about whether insurance companies paying taxes for stockholders can take the deduction.

Senator MCLEAN. Banks are making a good deal more money than life insurance companies just now, and I do not see why the stockholder should not have the same right.

Dr. ADAMS. If you adopt this for banks and other corporations I think you ought to adopt it for life insurance companies.

Senator MCLEAN. I move that it be adopted, Mr. Chairman.

Dr. ADAMS. What do you wish to do with No. 30?

The CHAIRMAN. If there is no objection, it is agreed to.

Mr. BEAMAN. Lines 10 and 11. That is about the same thing. It relates to interest deduction. It was inadvertently left out of this print. That is page 106, lines 10 and 11. You have done the same thing in two other places.

The CHAIRMAN. If there is no objection, it is agreed to.

Dr. ADAMS. No. 31 would give a specific exemption of $2,000 to life insurance companies.

Senator WATSON. That is a compromise agreement that is going to shift the corporation exemption of $2,000 somewhat and limit it to corporations having an income of $25,000 and over.

Dr. ADAMS. If you adopt it at all, life insurance companies should have the same specific exemption that other corporations have.

Senator WATSON. Then you would save trouble, because that is the proposal that is coming to us as a part of this arrangement, if you are going to agree to it.

Senator SMOOT. I see no difference in principle.

Senator CURTIS. Yes. Make it the same as the others.

Dr. ADAMS. Amendment No. 31 should be adopted with the understanding that if you change the $2,000 exemption life insurance companies will go along with the other corporations.

The CHAIRMAN. If there is no objection, the modification as submitted by Senator Watson will be agreed to.

Dr. ADAMS. You have limited to four and five years the right to change or amend assessments and to bring suit. This provision would say that no suit or proceeding shall be begun "in any court." The present provision is apparently that no proceeding shall be begun, in court or out of court. Not infrequently we assess a man and do it promptly. We may assess him six months after he makes his return and find out there is some fraud or delinquency; but we can not find any property of the taxpayer. He gets his property out of the jurisdiction. Then, some time later, he brings some property within the jurisdiction of the collector concerned. If you say that no suit or proceeding shall be begun in that case, we can not distrain. If you say no suit or proceeding shall be begun in any court, we can distrain. While I think it ought to be done, I

am not certain that you gentlemen will think so, and I do not want to "get it over" without your understanding it.

The present limitation in the statute is that after a period of five years no suit or proceeding shall be begun. What I propose to say is "no suit or proceeding in any court shall be begun." That will bar us from starting a court proceeding, but it will leave open other proceedings. In case assessment has been made in due time, promptly, or in case suit in court has been begun, and we have obtained judgment, we can distrain on the man's property if he ever comes back.

If you want to stop every sort of proceeding, leave the amendment as you have it. If you want to leave the department open to distrain beyond that limit, adopt this amendment.

Suppose a taxpayer makes a fraudulent return. We get around to that in proper time. We do not delay it. We investigate the return and find it is wrong and we make an increased assessment. That may be done with the greatest promptitude. We may even take it to court and get judgment. But suppose when we attempt to collect it the man has left and got all his property out of the jurisdiction. We can not touch him.

Then, three or four years later, he thinks the matter has been hushed up and that the situation has quieted down. Then the department thinks we ought to be permitted to go ahead with distraint proceedings.

Senator SMOOT. I think so, too; and I move that it be agreed to.

The CHAIRMAN. If there is no objection, it is agreed to.

Dr. ADAMS. The next is a pure matter of grammar.

The CHAIRMAN. It is agreed to.

Dr. ADAMS. That, gentlemen, should be "possessions of the."

The CHAIRMAN. No. 34.

Dr. ADAMS. That is so technical that I would like to have Mr. Beaman explain it.

Mr. BEAMAN. The House bill contained a semicolon. In the print of this bill the printer erroneously put in a period——

The CHAIRMAN. My understanding is, Mr. Beaman, that you have full authority in the matter.

Mr. BEAMAN. We have no authority over this, Senator. We can not change it unless you vote to change it.

The CHAIRMAN. We have practically voted to change it, and given you authority. It is agreed to. The next is No. 35.

Mr. WALKER. That is the estate-tax refund.

Dr. ADAMS. You want to strike out section 411 of the estate tax, which gives a period of three years for refund. In accordance with the McCumber amendments we changed that period to four years by general rule. Section 411 conflicts with the general rule.

Senator MCLEAN. I move that that be adopted.

The CHAIRMAN. If there is no objection, the motion is agreed to.

Dr. ADAMS. No. 36. That is the amendment introduced by Mr. Wadsworth, changed to make a little more accurate, exempting cavalry units which do a little hiring.

Senator MCLEAN. I move that it be agreed to.

The CHAIRMAN. I think it is a very meritorious proposition.

Senator SMOOT. I suggested on the floor that we put in the words "conducted by such associations without profit." This was a compromise, and I suppose it is all right.

Senator MCLEAN. I move, Mr. Chairman, that it be adopted.

The CHAIRMAN. Is there any objection? The Chair hears none. It is agreed to.

Dr. ADAMS. You have a stamp tax on sales upon produce and cotton exchanges. In the cotton futures act and the future trading act there is an additional tax imposed under certain circumstances. Senator Lenroot thinks it best to have it stated here that the new tax shall be in addition to the present tax. It is a technical point.

The CHAIRMAN. If there is no objection, it is agreed to.

Dr. ADAMS. Page 272, line 11. You will recall in connection with refunds to taxpayers, but if the taxpayer has another tax to pay we give him a credit against his other tax, merely for his convenience and the Treasury's convenience. I want to add the word "crediting."

Senator WATSON. That does not change the existing situation, does it?

Dr. ADAMS. It merely extends it, sir.

The CHAIRMAN. If there is no objection, it is agreed to. The next is amendment No. 39.

Dr. ADAMS. That is one of those provisions which I explained to you at the last meeting, to make it certain that the extensions of time for refund, and so on, are retroactive. Under the very artificial methods of construing such provisions it is possible that that will be held to apply only to cases arising under the revenue act of 1921, now and in the future, while you specifically adopted it for the purpose of having it go back to assesments made under the revenue acts of 1917, 1918, and 1919, provided they were within the four-year period, this amendment simply making assurance doubly sure that what this committee wanted done will be done.

Senator SMOOT. Is that agreed to?

The CHAIRMAN. If there is no objection, it is agreed to.

Dr. ADAMS. The next depends upon the same point made a moment ago.

The CHAIRMAN. It is agreed to. The next is No. 41.

Dr. ADAMS. That is another one of these retroactive provisions to make certain that these limits which you have established apply to prior acts.

The CHAIRMAN. It is agreed to.

Dr. ADAMS. No. 42 is the same provision about "in any court" that we have had.

The CHAIRMAN. That is agreed to. No. 43.

Dr. ADAMS. That is to make it certain that this section relates to all internal-revenue taxes and is not confined to one particular kind.

The CHAIRMAN. That is agreed to.

Dr. ADAMS. No. 44 is a provision relating to penal bonds, and where the bonds are to be kept. The present law says they shall be deposited, among other places, with an Assistant Treasurer of the United States. They have been abolished for the most part.

It is also provided that they may be deposited in any Government depository, but the Treasury Department believes that is a little dangerous at the present time, because those depositories may be little country banks. We are afraid some of them may be robbed. We ask to strike out the provision that assistant treasurers may be depositories. They have disappeared. We also want to say that the only depositories shall be Federal reserve banks or other depository duly designated for that purpose by the Secretary.

Senator SMOOT. Why do you say there are not any assistant treasurers?

Dr. ADAMS. I understand that except in Washington there are now no assistant secretaries.

The CHAIRMAN. The amendment is necessary. If there is no objection, it will be agreed to.

Dr. ADAMS. No. 45 relates to affiliated corporations. The bill contains a retroactive provision relating to consolidated returns under the revenue act of 1917. The general purpose of this provision is to validate existing practice and existing regulations, but those regulations exempted or excepted certain public utility companies. This fact or exception is not specifically mentioned in the proposed bill, but I think it should be. Some of these public utilities which did not make a consolidated return say they ought not be required to do so now. They would almost always gain if they did it. This is to confirm the old regulations, and is what we all supposed was being done when the provision was first approved.

The CHAIRMAN. If there is no objection, it is agreed to.

Dr. ADAMS. I hope you will adopt No. 46, Mr. Chairman.

The CHAIRMAN. I understand it is agreed to. If that is the pleasure of the majority present, it will be done.

Dr. ADAMS. Gentlemen, will you take enough time now to clean up all these retroactive corrections?

The CHAIRMAN. Proceed, Doctor. Is it purely technical?

Dr. ADAMS. Absolutely; but I do not want to do it unless you direct me to do it. I will pass around to the members of the committee these typewritten copies of the amendments referred to.

Senator LA FOLLETTE. It is strictly in accordance with our understanding.

The CHAIRMAN. It is agreed that Dr. Adams shall be authorized to insert in the bill at the proper places amendments referred to in the accompanying typewritten statement.

(The amendments referred to and submitted by Dr. Adams are as follows:)

"RETROACTIVITY OF SECTION 250.

"Page 113, line 4, after the word 'return,' insert the following: 'made under the revenue act of 1917, the revenue act of 1918, or this act.'

"Page 118, after l ne 17, insert the following paragraph:

"'(h) The provisions of subdivisions (e), (f), and (g) of this section shall apply to the assessment and collection of taxes which have accrued or may accrue under the revenue act of 1017, the revenue act of 1918, or this act.'"

Dr. ADAMS. The only other matter of importance that I have to present is the insurance amendment. Do you desire to d scuss that now or leave it for the afternoon session? Mr. Fordney has asked me to bring up an important matter.

The CHAIRMAN. Suppose you bring those things up at 3 o'clock this afternoon.

(Whereupon, at 12.30 o'clock p. m., the committee took a recess until 3 o'clock p. m.)

AFTER RECESS.

The committee met at 3 o'clock p. m., at the expiration of recess.

Dr. ADAMS. There is the matter to which Senator Sutherland referred.

There has been organized in this country a shipowners' mutual protection indemnity association. I think primarily its purpose is to take care of damage to ships and possibly liability for injuries to sailors which the marine insurance companies do not look after.

As I understand it they get assessments from their members and the association agrees to meet these liabilit es. It is something like a mutual insurance company, but unfortunately it does not have that exact technical status. In any event it is stated that the department is trying to tax this association on income based on assessments. I think that would be an unwise and a wrong proceeding.

They ask to be exempted *eo nomine*. I rather protest against that, because my feeling is that you should not give exemptions to associations as such. That point was rather agreed to in general, and I was left to shape up some amendment. I have developed this amendment that I think takes care of the matter in the proper way.

This would go in under section 213, among those clauses which state the classes of receipts excluded from gross inconre. It reads as follows:

On page 37, after line 10, insert the following language:

"(9) The receipts of shipowners' mutual protection indemnity associat'ons, not organized for profit, and no part of the net earnings of which inures to the benefit of any private stockholder or member, but such associations shall be subject to the tax upon their net income from interest, dividends, and rents."

That is to say, if these associations collect assessments and contr butions from their members, which they do, they hold them as an investment. This would make the interest they receive, less expenses of investment, subject to taxat on. The main contribution or assessments would not be taxed.

Senator SMOOT. Their contributions are about the same as premiums, are they not?

Dr. ADAMS. It is much like a bank deposit.

Senator LA FOLLETTE. This is for shipowners' indemnity against the loss of a ship, is it?

Dr. ADAMS. For m'scellaneous damages to ships, possibly including injuries to sailors. I do not thoroughly understand the scope of the association.

Senator LA FOLLETTE. I think I can get some information on that.

Dr. ADAMS. I think possibly they may do something along the line of marine insurance, but as I understand it, it is not an insurance company because it is not under any State law. It can not be treated under the provisions relating to insurance companies. If it could, it would be taken care of automatically.

Senator LA FOLLETTE. Can you give the name of any company?

Dr. ADAMS. This is the Shipowners' Mutual Protection Indemnity Association.

Senator LA FOLLETTE. Do you know where it is located?

Dr. ADAMS. I do not know where it is located.

Senator LA FOLLETTE. I have never heard of it.

Senator SMOOT. Why not let it go over, and if it is all right, offer it on the floor of the Senate.

Dr. ADAMS. Senator Sutherland asked me to bring it up this morning.

Senator LA FOLLETTE. I do not offer any objection.

Senator CURTIS. My own judgment is that it should be looked into rather thoroughly.

Senator SMOOT. If you have other amendments, present them now, Dr. Adams.

Dr. ADAMS. Let me take up fire and miscellaneous insurance companies. This is an important matter. At the present time you have a special scheme of insurance for life insurance companies, and the fire insurance companies are left under existing law. The law relating to insurance companies to-day is highly defective. Under the strict letter of the law there is a possibility of duplicating the same deductions three times.

The difference arises from attempting to apply deductions applicable to ordinary corporations to insurance companies and then adding certain special deductions to which insurance companies are entitled. In the plan presented here the income and deductions are expressed in their own technical terms. All these insurance companies, as you know, have to make reports every year. Those are uniform reports. They are carefully worked out, and the interests of the public are properly safeguarded. In the proposed amendment the terms used in this report are employed. It starts out in this way: The ordinary insurance company has a possibility of making two kinds of profits: that is, it collects premiums from policyholders and on these it may make an underwriting income. Then they invest these funds, and have an investment income, and there is a possibility of a net income from that source. This plan starts out by saying that insurance companies shall be taxed upon their net underwriting income plus their net investment income, if any. Then the whole scheme of computing net income has, as is necessary in the case of insurance companies, to be on the accrued or incurred basis instead of on the actual cash basis. That is the basis of this uniform report, and it is adopted here.

Senator SMOOT. Do I understand you to say that the tax would be imposed upon the accrued earnings of the company?

Dr. ADAMS. Yes.

Senator SMOOT. But the premiums have accrued many times and still are not paid.

Dr. ADAMS. It is essential that that should be done.

Senator SMOOT. But what I want to get at is just what you want.

Dr. ADAMS. Let me take that up. From the amount of gross premiums written on insurance contracts during the taxable year deduct return premiums (in the case of mutual companies dividends or unabsorbed premiums returned or credited to the assured) and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year. That is the proper basis. You have got to place it on an accrued or incurred basis or you can not get it straight.

Take the case of that marine insurance company referred to so frequently. The loss when paid must be referred back to the year when the corresponding premiums were collected or you get all sorts of monstrous results.

Suppose the agent of a fire insurance company writes a premium to-day, the 8th day of October, and the man does not pay the premium until the 15th day of this month. If his place burns down before that he gets his money. That is an illustration of the circumstances which makes it necessary to put the accounting on an accrued basis rather than on a cash basis.

Senator SMOOT. The only case that I can think of where there would be a hardship is where an individual takes out an insurance policy and the company takes notes—two months, four months, six months, eight months. They may be paid. The note for two months may be paid, the note for four months may be paid, but it may happen that the man will not be able to pay the six and eight months' notes.

Dr. ADAMS. They are given a deduction for that. Any such item that is put in they are permitted to deduct if the note becomes worthless.

Senator SMOOT. That is the only case where I can see where an accrued premium, if taxed as provided there, without credit, would work a hardship.

Senator DILLINGHAM. May I ask you a question, Dr. Adams?

Dr. ADAMS. Certainly.

Senator DILLINGHAM. In Vermont one of the largest mutual insurance companies has a system something like this: They take a premium note based on a certain percentage of the cost of the property. They take it up from every sum they insure. At the end of three months they estimate the losses and make an

assessment on that note. They do that four times a year. Now, what would be considered the premium?

Dr. ADAMS. It would be the amount they got on the note, but they are supposed to credit the man——

Senator DILLINGHAM (interposing). They treat the note as the premium?

Dr. ADAMS. In the first instance; yes.

Senator DILLINGHAM. I thought they had some difficulty with you.

Dr. ADAMS. That is because the present income tax law starts out on the cash basis and then afterwards authorizes deductions on both the cash and the accrual basis. You do not know where you are. I will read the language of the amendment covering your point:

"The term 'premiums earned on insurance contracts during the taxable year' means an amount computed as follows:

"From the amount of gross premiums written on insurance contracts during the taxable year deduct return premiums (in the case of mutual companies, dividends, or unabsorbed premiums returned or credited to the assured)."

I want to call special attention to this. Because of the multiple deductions very wrongly given and very mistakenly given in the present law, there are certain mutual companies that wholly escape taxation. They pay nothing at all. This is going to make those companies pay some tax. You will hear from them, but I see no reason why they should not pay the tax on the same basis as other companies. They will get every deduction that I can see under any right solution of this problem they ought to get. Along with other companies they have been relieved of the heavy tax imposed under Title V. They were subjected for years to some tax under the income-tax law, but under the changes made in the revenue act of 1918 they were practically exempted.

Senator DILLINGHAM. May I go back to that other question for a moment? Those companies issue a 5-year policy and take a note covering that. Under this plan that would give opportunity to make an annual settlement.

Dr. ADAMS. They would only include the portion of the note earned each year. That is the reason for putting it on the ground of the premiums earned.

Senator SMOOT. As to those that would be taxed, the tax would be imposed upon the interest that may be received from the investment—the invested capital.

Dr. ADAMS. They would get deductions for all amounts of premiums returned to policyholders or credited to policyholders. That would be a deduction under the language just read.

Senator SMOOT. But that does not relieve them from paying taxes upon the interest—upon the money invested.

Dr. ADAMS. This will subject net investment income to taxation.

Senator SMOOT. If we adopt that principle you can go through the bill and make the other corrections that are necessary.

Dr. ADAMS. Yes; a number of adjustments should be made in the income-tax sections. I would like to have this plan carefully considered. I would like to have something like this in effect when I leave Washington, which I hope I shall be able to do shortly and thus relieve you of my constant presence. I will then have the satisfaction of seeing on a workmanlike basis a thing which has never been on a workmanlike basis so far.

Senator SMOOT. I do not see any objection to it.

Dr. ADAMS. This does not begin until January 1, 1922.

Senator SMOOT. I move that we approve of this suggested amendment, and that the necessary amendments throughout the bill to conform with this amendment, as affected by other insurance companies, be made by Dr. Adams.

The CHAIRMAN. The committee has heard the motion made by Senator Smoot. What is the pleasure of the committee?

It is agreed to.

What is next?

Dr. ADAMS. Before Senator Sutherland came in I had taken up the question of the shipowners' mutual indemnity association. I did not get a complete understanding of the nature of their business. Perhaps Senator Sutherland can tell you.

The CHAIRMAN. This amendment was submitted by three men, one of them from the Shipping Board, and was introduced by Senator Sutherland. They wanted their situation covered by an amendment which Dr. Adams was requested to submit.

Senator Sutherland, perhaps you can explain who they were and the nature of the relief association. There is only one case in the country, I may say, that is covered by this amendment.

Senator SUTHERLAND. One of the men was formerly a Member of the House of Representatives—Joseph H. Gaines—and he is now connected with the Shipping Board. I think another is also connected with the Shipping Board, and the other man represented this marine indemnity company, which is purely a mutual company insuring ships against liabilities while in operation. It is all for operating damages.

For instance, if you have caused damage to another vessel, or caused damage to dock, or have caused any sort of damage during operation of these vessels, such damages are provided for. They pay in a certain amount, by assessment, every month or every so often. There are no profits that accrue to anyone. These sums of money are held until damages are ascertained and paid. If they have invested funds, those funds are used in the same way. There are absolutely no profits to anyone; it is simply a fund from which is drawn any sum necessary to indemnify the members of this concern against liability for operating damages.

Senator LA FOLLETTE. What is the name of that concern, Senator Sutherland?

Senator SUTHERLAND. I do not know. I had never seen or heard of them until the other day. There is only one concern of this kind. Seventy per cent of the vessels, or tonnage, covered by this company are Shipping Board vessels. The rest are miscellaneously owned vessels. As I have already said, it is not operated for profit at all. It is money simply put in a fund, just as farmers or mutual concerns of any other kind put money in funds. They pay out this money if there is any damage done at any point on the globe wherever the vessels may be operated. Of course, it takes months sometimes to ascertain where the liability developed, so that if there is an assessment in excess of damages paid out, they do not distribute that; they hold it there. There is no profit to anyone. It is simply a fund which is mutually put together for the purpose of indemnifying themselves against all these miscellaneous liabilities.

Senator SMOOT. Do you know whether they do an insurance business outside of their membership?

Senator SUTHERLAND. Not at all; there is no insurance business outside; it is purely a mutual arrangement with reference to this class of liability which is not covered by straight marine insurance.

Senator LA FOLLETTE. Injuries to vessels are covered by marine insurance, are they not?

Senator SUTHERLAND. That is, as to the hull. These are injuries other than hull injuries. For instance, an injury to a dock caused by a vessel operated would not be covered by marine insurance. That is covered by this concern. All other kinds of liability indemnity other than the insurance that is covered by straight marine insurance is under this——

The CHAIRMAN. What income do they have from interest, dividends, and rents?

Senator SUTHERLAND. They said the other day, in your presence, they had some invested funds. Those funds are used in the same manner as assessments for that purpose—not distributed, but simply held as funds for the purpose of settling liabilities.

The CHAIRMAN. They are liable to pay them?

Dr. ADAMS. That was the point. They asked for a flat exemption. I think, personally, that is unwholesome. I think these organizations ought to make some kind of a report. I suggested that instead of taking a complete exemption on everything, they should do what I have suggested here.

Senator SUTHERLAND. I think this amendment that you have would cover it.

Senator SMOOT. Do they invest in stocks of any kind?

Senator SUTHERLAND. Not at all. I think they have Government bonds.

Senator SMOOT. Then they would not have dividends.

Senator SUTHERLAND. Where they have a certain amount over current liabilities, I think they invest that.

The CHAIRMAN. Have they seen this amendment?

Senator SUTHERLAND. No.

Senator SMOOT. So far as I am concerned, I would like to go into it a little further in order to see what this association does by way of investment.

The CHAIRMAN. I do not think we know anything about it.

Dr. ADAMS. I think Senator Sutherland has given you the point. I understand that under the auspices of the Shipping Board a large mutual organization has been formed for the purpose of taking care of a class of risks not taken care of by the ordinary insurance companies, and that the Treasury Department has

taken, according to them, a very rigid attitude—and I think from what they told me, an improper attitude—toward their income from assessments. They say the department proposes to tax them this year $178,000.

Senator SMOOT. It is quite a business, then.

Dr. ADAMS. It is as if we made a pool and chipped in a certain amount here. Then the department regards that chipping in as income to the pool and proposes to tax the pool on that income.

Senator CURTIS. Mr. Chairman, why not authorize Senator Sutherland to make a report on this.

Senator SMOOT. I have no objection to that.

Senator SUTHERLAND. It is purely a mutual affair.

The CHAIRMAN. The trouble is, Senator Sutherland, that none of the committee is informed as to the nature of the company or where it is located. We know that there is only one such company. That does not seem just right.

Senator SUTHERLAND. I shall be very glad to get any information the committee desires. I talked to them only one time. They made their statement in your presence.

The CHAIRMAN. I talked to them, but I am not prepared to recommend this or say anything one way or the other.

Senator SUTHERLAND. I think their statement can be depended upon absolutely. Two officers of the Government were present, and they certainly have no desire to put anything over on us. They say there is absolutely no profit connected with it—no profit to anybody—but I shall be very glad to get additional information, if the committee desires it.

Senator SMOOT. I reserve the right to make an investigation of it. If I think that it is not right, I shall make objection to it on the floor of the Senate.

Senator SUTHERLAND. That will be perfectly satisfactory.

Dr. ADAMS. I am not certain that these gentlemen will be willing to accept this.

Senator SMOOT. They will accept this or nothing.

The CHAIRMAN. What is the pleasure of the committee?

(Informal discussion followed.)

Dr. ADAMS. Then the Senator will take care of it. It will not go into the committee amendment?

Senator SUTHERLAND. It could be put in as a committee amendment.

The CHAIRMAN. No, Senator Sutherland. These have got to be offered on the floor. They come from the majority of the committee at an informal meeting.

Dr. ADAMS. Chairman Fordney, of the Ways and Means Committee, telephoned me this morning and asked me to bring up the following subject.

The CHAIRMAN. What is it, Doctor?

Dr. ADAMS. The subject matter is the Kellogg amendment. That was a question of dividends distributed from earnings accumulated prior to March 1, 1913. There is another angle to that same subject.

Suppose, for instance, corporation A, which has profits accumulated prior to March 1, 1913, distributes those profits to stockholders. Then it is subject to the Kellogg amendment adopted this morning. But suppose, instead of distributing its earnings directly to ordinary stockholders, it pays them to an intermediate corporation? Corporation A, for instance, having earnings, passes them to corporation B, and corporation B, in turn, distributes them to its stockholders. In accordance with long-established rules of the Treasury Department, we hold that earnings and receipts paid by one corporation to another corporation, roughly speaking, lose their identity in the coffers of the second corporation, and that they do not carry the exemption with them when distributed thereafter.

Mr. Fordney wants an amendment—and Mr. Beaman has drafted one very skillfully—which will carry that exemption on down. That is the substance of it. I think you had better discuss it in principle and then take up the language later.

The CHAIRMAN. How much money will it take from the Treasury?

Dr. ADAMS. It is simply a question of deciding whether, if you adopt the Kellogg amendment, you shall also adopt this intermediate corporation proposition.

Senator SMOOT. Do you mean a new corporation organized after March 1, 1913?

Dr. ADAMS. It might be any corporation.
Senator SMOOT. I know. I think I understand.
Dr. ADAMS. I have made it plain, I think.
Senator SMOOT. Yes; I understand that.
(Informal discussion followed.)
Dr. ADAMS. The point is this: Obviously, you can not, under ordinary circumstances, identify the ingredients of a corporation's income. For instance, take tax-free interest received by a corporation which has both taxable and tax-free income, and later pays a dividend. When the dividend is distributed you can not tell exactly from what source it came. Mr. Fordney wants to take these cases where profits accumulated prior to March 1, 1913, are paid by corporation A to corporation B and corporation B, in turn, distributes them to stockholders, and under proper safeguards, which Mr. Beaman has drafted, exempt the stockholders of B when the dividend can be identified as coming from profits accumulated prior to March 1, 1913. Mr. Fordney wants to get that exempt, subject to the same safeguards and conditions applied in the Kellogg amendment.
Senator SMOOT. There is a chance there to buy stock of B and pay lower rates.
Senator LA FOLLETTE. Inasmuch as your amendment is up, in order that we may be informed, how much more than the $15,000,000 that the Kellogg amendment loses will the Fordney amendment lose?
Dr. ADAMS. The only way I can answer that is this: These distributions are not of large volume, but they are made frequently to wealthy stockholders. I mention that because they are subject to heavy surtaxes. I do not know how much money is involved. Among the interests which have accumulated large profits prior to March 1, 1913, it is frequently the practice for corporation A to own stock in corporation B. That is innocent enough. Now, when they want to distribute this surplus the easy way is to send it back through A.
Senator SMOOT. Don't you see, Dr. Adams, that it could be used in a way that would be very unfair or very advantageous to stockholders? Take, as an example, a company that does not distribute and, secondly, a company that does distribute. Suppose that there are those who know beforehand what is going to be done. If it is going to be distributed to B, perhaps the stockholders would buy stock heavily before the transfer is made to them, and then when the transfer is made to stockholders of B they would get the advantage, and those that sold out would not get the advantage of that transfer. It seems to me that there is a chance of handling there that ought to be considered.
Senator MCLEAN. It is a question of robbing the minority stockholders of a considerable amount of money.
Senator SMOOT. I can not see it any other way. It looks like a chance to get the undistributed profits made before March 1, 1913.
The CHAIRMAN. What is the pleasure of the committee?
Senator WATSON. Is there any amendment offered?
Dr. ADAMS. I told Mr. Fordney I would bring it up. I think the amendment should be acted on.
Senator MCLEAN. Would it not provide a way for the minority stockholders to be defrauded?
Dr. ADAMS. Senator, I do not see that.
Senator MCLEAN. Suppose you have 50 stockholders entitled to this surplus in this original company and the majority of the stockholders vote to pass on this surplus to some other company.
Senator SMOOT. Because they own a greater interest.
Dr. ADAMS. It must go to all alike.
Senator MCLEAN. The stockholders who pass it on are minority stockholders, but the others are not interested in the other company.
Dr. ADAMS. I do not see that.
Senator MCLEAN. When the surplus was earned, I mean.
Senator LA FOLLETTE. Is it not our concern not to put something in that will rob them?
Dr. ADAMS. I do not see how it can do that. Take corporation A, for instance. A's stock is owned by 10 stockholders, we will say. Assume that the minority stockholders represent 40 per cent and the majority stockholder, a corporation, 60 per cent. A has a lot of profits accumulated prior to March 1, 1913. It makes one of these nontaxable distributions; 40 per cent goes to the

individual stockholders; 60 per cent goes to corporation B. Now, I do not see any chance for abuse there. B, in turn, disposes of or distributes its part to its stockholders. It would go tax-free to those under the amendment.

Senator McLEAN. But the minority stockholders in company A are entitled to something.

Dr. ADAMS. They get that.

Senator McLEAN. But they get 40 per cent and you suggested passing on the 60 per cent.

Dr. ADAMS. Sixty per cent goes to corporation B.

Senator SMOOT. B may not have the same stockholders as A. In other words, the majority stockholders in A may own the greater part of the stock in B and thereby get a greater amount of distribution.

Dr. ADAMS. I do not see anything wrong in that.

Senator SMOOT. I think this, that if I own 60 per cent of a company, or 55 per cent of a company, I would be a majority stockholder in A; and if I owned 90 per cent of the stock of B I would very much prefer, as a majority stockholder, to vote that undistributed dividend to B and then declare a dividend and get 90 per cent rather than the 55 per cent.

Senator McLEAN. It seems to me so, if I understand the proposition.

Senator SMOOT. If the stockholders were exactly the same and owned exactly the same number of shares, then there would be no objection to it; but they would have to be exactly the same stockholders, owning exactly the same percentage of shares, if it is to be fair; and if it is not that way, then it would be unfair and somebody would get hurt.

Senator McLEAN. Suppose you had $100,000 surplus in your original company and you have a stockholder in that company who is entitled to his share. Suppose you divide 20 per cent of that surplus. This one stockholder gets his share of that surplus. Now, the majority of the stockholders in the original company pass the other 80 per cent of surplus to another corporation. This single stockholder in the original corporation does not get in.

Dr. ADAMS. But he was only entitled to one one-hundredth. He got his share.

Senator McLEAN. Yes; but you are passing 80 per cent that is not distributed.

Dr. ADAMS. You say he owns what per cent?

Senator McLEAN. He has one share, or anything you say.

Dr. ADAMS. The other 99 shares, or 99 per cent, are owned by the other corporation. That is the case?

Senator McLEAN. Yes.

Dr. ADAMS. Ought they not get 99 per cent?

Senator McLEAN. No; not of the 80 per cent remaining, out of which he is entitled to the interest represented by one share.

Dr. ADAMS. He will get his share of the 80 per cent if the first corporation decides to distribute that.

Senator McLEAN. They are going to distribute it.

Dr. ADAMS. You can not squeeze the minority stockholders.

Senator McLEAN. Then I do not understand your proposition.

Mr. BEAMAN. The proposition is this: Take corporation A. We will say 40 per cent of the stock is owned by individuals; the other 60 per cent is owned by corporation B. They declare a dividend. Of that dividend 40 per cent goes to the individual stockholders and 60 per cent to corporation B. When corporation B comes to distribute the 60 per cent the stockholders find that under the present law they are taxed.

Senator McLEAN. Do you propose to dispose of all the surplus?

Mr. BEAMAN. It does not make any difference whether it is disposed of in whole or in part. Whatever they give, in the course of business, to corporation B is what Mr. Fordney has in mind. Mr. Fordney wants the distribution, when corporation B comes to distribute, to be kept in the hands of corporation B stockholders.

Senator SMOOT. He would put the stockholders in B that are not in A?

Senator McLEAN. That is, what is left. It is only the portion of the distribution.

Dr. ADAMS. The only thing that Mr. Fordney asks for is this, that you permit receipts of this kind to preserve their identity when distributed by the second corporation.

Senator SMOOT. I thought your proposal was to distribute all surplus?

Dr. ADAMS. Not at all.

Senator LA FOLLETTE. Mr. McCoy has an idea that bears upon the amendment. What is it, Mr. McCoy?

Mr. MCCOY. The idea is that the part of the earnings distributed to the corporation could further be distributed without any tax. But how about the part that is distributed to the other stockholders? That has to be taxed, and then it is passed on and there would not be any equality.

Dr. ADAMS. Let us see about that. Suppose I, as an individual stockholder, get one of these dividends. It is my money. If I pass it on to somebody else it is not taxable—that is, if I distribute it or give it away. It is a gift.

Senator SMOOT. Why give it to a stockholder in B who was not in A? There is something there that I do not understand.

Dr. ADAMS. He gets only his pro rata share of B's share of the surplus accumulated prior to March 1, 1913.

Senator SMOOT. He gets his share in whatever you transfer to B if he is a stockholder in it.

Senator SUTHERLAND. I have moved that we adopt it.

The CHAIRMAN. It is moved that it be adopted as indicated.

(After a pause.)

It is not agreed to.

Dr. ADAMS. I have only one other small amendment, and we are through.

Senator WATSON. Did you consider the one Senator Lodge sent over?

Dr. ADAMS. Oh, yes. Gentlemen, that relates to the capital-stock tax. I do not think you can consider that until you have determined whether you will accept the bloc proposition. I will bring that up as soon as you have done that.

Senator WATSON. I think that is true.

Dr. ADAMS. On page 79, line 18, strike out the word "or" and insert "and corporations organized." That has to do with fraternal benefit societies, and is suggested by the Commissioner of Internal Revenue for the purpose of clarity. It now reads:

"Fraternal beneficiary societies, orders, or associations (a) operating under the lodge system or for the exclusive benefit of the members or beneficiaries of members of a fraternity itself operating under the lodge system."

As amended it would read:

"Fraternal beneficiary societies, orders, or associations (a) operating under the lodge system and corporations organized for the exclusive benefit of the members," and so on.

This second part which I just read, "and for the exclusive benefit of the members or beneficiaries of members of a fraternity itself operating under the lodge system," is meant really to take care of the large and important auxiliary associations which some organizations carry, particularly to handle their insurance features. In order to make that perfectly clear, the Assistant Commissioner of Internal Revenue, who is an expert on this question, has suggested that after the words "lodge system" you strike out the word "or" and insert "and corporations organized."

The CHAIRMAN. That does not add anything to it. It expands the language. Mr. Walker wants to submit a suggestion.

Mr. WALKER. Mr. Smith, the Assistant Commissioner of Internal Revenue, sent me a letter saying there was only one trust company that is depository for stamp taxes, and that is the Empire Trust Co. of New York, and that at the present time that company is required to give a bond of $500,000 in order to handle stamps. There is a provision on page 238 requiring it to give a bond equal to the full face of the adhesive stamps on hand, which requires them to give a bond of $4,000,000, because it has that many stamps on hand sometimes. He suggests that we strike out, on page 238, lines 2 and 3, the words, "to an amount equal to the full value of the adhesive stamps so furnished," and insert "in a sum to be fixed by the commissioner." The idea is to continue the bond of $500,000. It costs $2,500 premium per annum at the present time. The bond of $4,000,000 would cost $20,000 per annum. The handling of these stamps is a convenience to customers.

Senator CURTIS. That should be a bond in the discretion of the commissioner, it seems to me.

Mr. WALKER. That is the suggestion.

The CHAIRMAN. Why does only one concern do that business?

Dr. ADAMS. New York State has a stock-transfer tax. We also have a stamp tax on stock transfers. The Empire Trust Co. is the special agent of New

York State. It is highly convenient for them to be able to have Federal stamps and sell them. They do it as a convenience to the Government and their customers. They make no money from it. They are now required to give a bond of $500,000. They think that is enough, because they make no money out of it.

Senator McCUMBER. Is there not sufficient business in Boston, and Philadelphia, and Chicago, and Los Angeles for that sort of a concern?

Dr. ADAMS. Any other company that complies with the conditions of the statute can enter the business.

The CHAIRMAN. Why do not other companies want to do it?

Dr. ADAMS. I do not know. I suppose it is the trouble and expense. No other State has such a law.

Mr. WALKER. They can get stamps from all post offices.

(After a discussion of various features of the bill, which was not reported, the committee adjourned at 5.15 p. m., to meet again on Monday, the 10th day of October, 1921, at 10 o'clock a. m.)