REPEAL OF SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954

MAY 23 (legislative day, MAY 2), 1955.—Ordered to be printed

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

REPORT

[To accompany H. R. 4725]

The Committee on Finance, to whom was referred the bill (H. R. 4725) to repeal sections 452 and 462 of the Internal Revenue Code of 1954, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

1. Under section 4 (a) and (b) of the House bill taxpayers have until September 15, 1955, to file a statement showing the increase in tax required to be paid solely by reason of the retroactive repeal of sections 452 and 462 and to pay the increase in tax which is due on or before that date. Your committee has extended this date to December 15, 1955, in all instances.

2. Under section 4 (c) of the House bill a taxpayer is given additional time to make timely payments where the payments are required to be made to another person by reason of this bill and the taxpayer was otherwise allowed a period in which to make the payments after the close of its taxable year. An amendment extends this provision, for purposes of the accumulated earnings tax, the personal holding company tax, and the taxation of regulated investment companies, to cover dividends which are paid after the due date of the return (without regard to any extensions) and on or before December 15, 1955. This treatment of dividends is applicable only to the extent that the dividends are attributable to an increase in taxable income resulting from this bill and only if the taxpayer so elects.

3. Two clarifying amendments have been added to the House bill. The first amendment insures that the saving provision applies only to taxable years ending on or before the date of enactment of this bill. The second clarifying amendment provides that an increase in tax, which arises because of the effect of the repeal of sections 452 and 462 on a net operating loss, is not to be treated as tax shown on the return for purposes of the statement required to be filed under section 4 (b) (2) of the bill.

PART I. SUMMARY OF BILL

Section 1 of the bill repeals sections 452 and 462 of the Internal Revenue Code of 1954, relating to prepaid income and reserves for estimated expenses, respectively.

Section 2 contains technical conforming amendments.

Section 3 provides that the amendments made by this bill are to apply to taxable years beginning after December 31, 1953, and ending after the date of enactment of the 1954 code.

Section 4 contains certain provisions designed to place, insofar as possible, taxpayers who elected the benefits of section 452 and section 462 in the same position they would have been in if these sections had not been enacted. The committee amendments to section 4 of the House bill give taxpayers until December 15, 1955, instead of until September 15, 1955, to comply with these provisions. Two additional changes are made by the committee amendments to the House bill which are described below.

PART II. SUMMARY OF SECTIONS 462 AND 452 OF EXISTING LAW

Section 462 of the 1954 code permits an accrual-basis taxpayer to deduct reasonable additions (in the discretion of the Secretary or his delegate) to reserves for various types of estimated expenses. The expenses placed in such a reserve must be related to income of the current or preceding years and must be of a type the Secretary or his delegate is satisfied can be estimated with reasonable accuracy. The reserves are required to be adjusted each year to reflect the best estimate available and any amount found to be excessive is to be taken into account in such year. A taxpayer, without the consent of the Treasury Department, can elect to establish reserves for estimated expenses for the first year beginning after December 31, 1953, in which he has such expenses. For subsequent years, however, the consent of the Treasury Department is required.

Section 452 of the 1954 code permits accrual-basis taxpayers to defer the reporting of advance payments as income until the year, or years, in which, under the taxpayer's regular method of accounting, the income is earned. Where the liability to perform services or supply property does not end within a 5-year period the income must be allocated to the 5-year period unless the Secretary or his delegate consents to a different allocation. In such cases taxpayers, unless they have the consent of the Treasury to do otherwise, are to take the prepayments into account ratably over the period of the taxable year of receipt and the 5 succeeding taxable years. Where a taxpayer dies or where, for any other reason, the liability with respect to the deferred income ceases, prepayments not previously reported as income become taxable at that time. The election provided in this provision is available without consent of the Treasury with respect to advance payments received by a taxpayer in his first taxable year beginning after December 31, 1953, in which he has prepaid income. For subsequent years consent of the Treasury must be obtained. If the election is made the treatment explained above must be applied to all income received in advance, during the year of the election and subsequent years.

PART III. REASONS FOR REPEAL OF SECTIONS 462 AND 452

The President in his state of the Union and budget messages to Congress in January of 1954 requested action on several tax proposals. Among these was one that the Congress act to bring tax accounting more nearly in line with accepted business accounting practice. In this budget message, presented in January 1954, item No. 20 of his tax recommendations was as follows:

Accounting definitions.— Tax accounting should be brought more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it is earned rather than as it is received, and by allowing reserves to be established for known future expenses.

On the basis of this recommendation, the Internal Revenue Code of 1954, as passed by the House, contained section 452, permitting the deferral of prepaid income and section 462, providing for reserves for estimated expenses. The estimate of the revenue expected to be lost as the result of the enactment of sections 452, 462, and certain other accounting provisions, as shown in the House report accompanying the Internal Revenue Code of 1954, was $45 million for the fiscal year 1955. The American Institute of Accountants this year estimated the revenue loss from sections 452 and 462 at $500 million. Others have expressed the view that the revenue loss from these provisions may run to several billion dollars. Your committee believes, however, that these estimates do not give proper recognition to an amendment made to section 462 by your committee last year.

When the bill providing for the Internal Revenue Code of 1954 came before your committee last year, concern was expressed that the revenue loss from sections 452 and 462 might well be above the amount then estimated in the report of the House Committee on Ways and Means. In the hearings held by your committee in 1954 a witness representing the American Institute of Accountants stated:

The bill makes great strides in the direction of putting business accounting and income-tax accounting on the same wavelength. This is something we have urged upon the Congress for many years. We applaud H. R. 8300 for getting it underway. The transition will bring on some problems, both from a revenue standpoint, as well as the scope of reserves for estimated expenses. For that reason, there is included in our list of recommendations certain cautions and restraints during the gearshifting period (hearings before the Senate Finance Committee on the Internal Revenue Code of 1954, p. 1312).

In the list of recommendations referred to above of the American Institute of Accountants there was the following statement:

Recommendation No. 136.— Section 462 (a): To avoid the impact on the revenues in the transitional year where there will be a deduction both for the actual expenses and the estimated expenses, and in order to avoid undue distortion of income, the addition to the reserve should be spread as a deduction over the transitional year and the 2 succeeding years.

It was your committee's awareness of this revenue problem which prompted it to amend section 462 to limit the additions to reserves for estimated expenses to those which could be taken into account in the discretion of the Secretary of the Treasury or his delegate. As amended by the Senate Finance Committee, section 462 (a) of the Internal Revenue Code of 1954 reads as follows:

GENERAL RULE.— In computing taxable income for the taxable year, there shall be taken into account (in the discretion of the Secretary or his delegate) a reasonable addition to each reserve for estimated expenses to which this section applies.

The Senate Finance Committee amendment passed the Senate and was accepted by the House conferees and thus became part of the 1954 code.

This amendment of the Senate Finance Committee was adopted in lieu of the recommendation of the American Institute of Accountants because it was believed that it provided a more effective control over any unreasonable revenue loss that might develop than the proposal of the accountants.

Frequently it is asserted that section 462 of the 1954 code provides for a double deduction. This, however, is an incorrect interpretation. As your committee's report last year on the accounting provisions in the Internal Revenue Code of 1954 stated:

> The changes embodied in the House bill and in your committee's bill are designed to bring the income-tax provisions of the law into harmony with generally accepted accounting principles, and *to assure that all items of income and deductions are to be taken into account once, but only once in the computation of taxable income.* [Emphasis supplied.]

Rather than being a problem of double deductions, the problem presented by section 462 is that of the timing of deductions when a taxpayer changes accounting methods. The question is whether in the year a taxpayer shifts to the reserve method he should be entitled to deduct an amount equal to his addition to his reserve (representing expenses attributable to income of the current year but which in large part may not be incurred until subsequent years) and also expenses actually incurred in the year of transition but attributable to income of prior years. Whether these expenses are incurred in the current year or in a subsequent year, they would be allowable deductions under the code at some time even if section 462 were not in the law. It is, therefore, only a question of when the deductions should be allowed which constitutes a problem under this provision.

As indicated above, your committee last year recognized this problem in the timing of deductions where a taxpayer converts to the expense reserve method and believed that its amendment met the problem by giving the Secretary of the Treasury discretion over not only the amount of estimated expense to be added to the reserve for each taxable year but also the kind of items which entered into the estimated reserve. With such limitations in the section, it was the opinion of your committee that any revenue loss which might occur would be well within the limits of last year's estimate. It would appear possible, for example, for the Secretary to require the spreading of the deductions for actual expenses incurred in the year of transition to the reserve method, over an extended period of years, a period which could be much longer than that advocated by the American Institute of Accountants. It apparently is the opinion of the Secretary of the Treasury, however, that the words "in the discretion of the Secretary or his delegate" only limit the amount of the allowable deductions and not the type of items which can be deducted. (See p. 11 of House hearings on secs. 452 and 462.) The Secretary apparently is fearful of exercising the discretion which your committee intended him to have in this matter. He has expressed the view that some taxpayers may contest his decisions and that there may be prolonged litigation before the matter is ultimately decided.

It is because of the Secretary's fears and his desire to have a fresh review of section 462, relating to estimated expenses, and its counter-

part section 452, relating to prepaid income, and because of the House action repealing these sections that your committee has reluctantly concluded to report out the House bill repealing these sections from the effective date of their enactment. Since the Secretary has not, by regulations, exercised the discretionary limitations which your committee delegated to him in the law, it is apparent that the loss in revenue under these provisions may be much larger than was anticipated last year.

Your committee does not, however, believe that the repeal of these sections solves the problem presented. I. T. 3956 (1949 C. B., p. 78) which the Secretary of the Treasury in a letter to the chairman of the House Committee on Ways and Means promised to keep in effect through 1955, presents essentially the same problem as to the timing of vacation pay deductions as the present section 462 does generally. Moreover, if this I. T. is withdrawn for 1956, taxpayers who previously have been accruing vacation pay under this and similar rulings will be faced with the possibility of having no deductions for vacation pay in 1956.

The status of prepaid subscription income will also be uncertain as the result of the repeal of section 452. In I. T. 3369 (1940–1 C. B. 46) the Treasury ruled that publishers of periodicals on the accrual basis, who over a period of years for tax purposes had consistently deferred the reporting of prepaid income would be permitted to continue to file their tax returns on this basis. Moreover, one witness appearing before your committee stated that some of the rulings on prepaid subscription income granted in recent years have permitted the taxpayer to defer prepaid subscription income even though the taxpayer had not report his income for tax purposes in the past on this basis. Another aspect of the uncertainty with respect to subscription income if section 452 is repealed arises from a recent circuit court decision in *Beacon Publishing Company* v. *Commissioner* (C. C. A. 10th, January 3, 1955). The court in this case held that the deferral of prepaid subscription income was in fact proper under the accrual method of accounting. The Secretary of the Treasury in the letter previously referred to which he sent to the chairman of the House Committee on Ways and Means indicated that the repeal of section 452 would not be taken as an indication by the Treasury Department of congressional intent as to the proper treatment of prepaid subscription income under prior law or under other provisions of the 1954 code. He also indicated that the repeal of section 452 will not be considered by the Department as either acceptance or rejection by Congress of the decision in *Beacon Publishing Company* v. *Commissioner* or in any other judicial decisions. It has come to your committee's attention that the vast majority of publishing concerns having prepaid income are already deferring their income with Treasury approval. It is recommended to the Treasury Department that it modify its published ruling to the end that the remaining publishers may be entitled to defer prepaid subscription income so that they may be placed upon a fair and equitable basis.

Uncertainty will also exist in other areas with the repeal of these two provisions. In *Pacific Grape Products* (C. C. A. 9th, February 10, 1955), for example, the circuit court held that certain freight and shipping expenses incurred after the end of the year could be accrued for tax purposes as of the end of the year. An extension of the

principles laid down in this case might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed.

Your committee desires to make its position clear that it expects to report out legislation dealing with prepaid income and reserves for estimated expenses at an early date. As indicated above, the existing rulings of the Treasury Department and the court decisions dealing with estimated expenses and prepaid income are now in such a state of confusion and uncertainty that in the opinion of your committee legislative action is required on these subjects. In addition, your committee believes that it is essential that the income tax laws be brought into harmony with generally accepted accounting principles. Moreover, your committee believes that the present status, where some taxpayers are able to defer prepaid income while others are not, is inequitable and should not be allowed to continue. In order to eliminate this uncertainty and discrimination, definite rules must be written into the income tax law. For these reasons your committee plans to begin studies in the near future to devise proper substitutes for the sections now being repealed.

PART IV. DESCRIPTION OF SECTION 4 OF BILL

Section 4 of the House bill contains the savings provisions which are intended to alleviate to some extent the hardships imposed on taxpayers by the retroactive feature of the bill. Under the House bill this section provided that a taxpayer would be relieved from the payment of any interest which would otherwise be imposed by reason of the increase in tax resulting from the retroactive repeal of sections 452 and 462, if a statement were filed not later than September 15, 1955, and the portion of the increase in tax which is due on or before that date were paid not later than September 15, 1955. Your committee has extended this date to December 15, 1955.

Under the House bill, additions to tax would not be imposed with respect to the increase in tax resulting from enactment of this bill if the taxpayer filed a statement showing such increase in tax on or before September 15, 1955. Your committee has extended this date to December 15, 1955.

The statement which the taxpayer must file in order to be relieved of interest and additions to tax must be in the form prescribed by the Secretary or his delegate under regulations. The House bill provided that the amount which was shown on the statement as the increase in tax resulting from the repeal of sections 452 and 462 should be treated as "tax shown on the return." This rule should not apply, however, where the increase in tax is to any extent attributable to a decrease in the net operating loss for another year and the decrease in net operating loss arose because of the repeal of sections 452 and 462. Your committee's amendment so provides.

The effect of the retroactive repeal of sections 452 and 462 may, in certain cases, affect payments which the taxpayer is required to make to another person. Under the Internal Revenue Code the taxpayer may have a period of time after the close of the taxable year to make such required payments. The House bill provided that where the taxpayer's payments to another person were payments required by reason of this bill and the taxpayer was otherwise allowed a period in

which to make the payments after the close of the taxable year, any payments made on or before September 15, 1955, would be treated as having been timely made. Your committee has extended the period within which such payments may be made to December 15, 1955. Your committee has also provided, for purposes of the accumulated earnings tax, the personal holding company tax, and the taxation of regulated investment companies, that any dividends paid after the 15th day of the 3d month following the close of the corporation's taxable year and paid on or before December 15, 1955, are to be treated as though they had been paid on the last day of the taxable year to the extent that the dividends are attributable to an increase in taxable income for that year resulting from the repeal of sections 452 and 462. This treatment of dividends paid after the close of the taxable year and on or before December 15, 1955, is applicable only if the taxpayer so elects.

PART V. TECHNICAL ANALYSIS OF THE COMMITTEE BILL

Section 1 of the bill is identical to that of the House bill and repeals sections 452 and 462 of the Internal Revenue Code of 1954, relating to prepaid income and reserves for estimated expenses, respectively.

Section 2 of the bill is identical to that of the House bill and contains conforming amendments.

Section 3 of the bill is identical to that of the House bill and provides that the provisions of the bill are to apply to taxable years beginning after December 31, 1953, and ending after the date of enactment of the code.

Section 4 of the bill corresponds to the same section of the House bill with certain modifications made by committee amendments as hereinafter explained.

Subsection (a) is identical with the same provision of the House bill except that there is changed the date on or before which the statements are required to be filed from September 15, 1955, to December 15, 1955, and there is added a clarifying amendment to indicate that the saving provisions apply only to taxable years ending on or before date of enactment of this bill. Subsection (a) of this section requires a taxpayer to file a statement on or before December 15, 1955, showing the increase in the tax required to be paid by reason of the repeal of sections 452 and 462 of the Internal Revenue Code of 1954, if the due date for the payment of such increase or any installment thereof is before December 15, 1955. If the tax of more than 1 taxable year is increased by reason of the enactment of this bill, separate statements shall be filed for each such year. For example, if a net operating loss is decreased by reason of the enactment of this bill and the net operating loss has been allowed as a carryback to the 2 preceding years, separate statements are required if the net operating loss as decreased results in an increase in tax for such 2 preceding taxable years. The due date for payment is to be determined without regard to any extension of time granted for payment of the tax (including extensions arising by reason of sec. 4 of the bill).

Where one installment is so payable before December 15, 1955, the full amount of the increase required to be paid for the taxable year shall be shown on the statement, even though another installment is not due until on or after December 15, 1955. Where the taxpayer is required to file a statement, the increase in tax required to be paid

by reason of the repeal of sections 452 and 462 shall be determined by recomputing taxable income for the taxable year and any deductions or credits affected thereby.

It is contemplated that the Secretary of the Treasury or his delegate may, under his general regulatory authority under the Internal Revenue Code of 1954, require persons filing certain information returns, such as partnerships, to file a statement similar to that required under subsection (a) in connection with increases in taxable income resulting by reason of the enactment of the bill.

By reason of the enactment of the bill, shareholders of a corporation may be required to file the statement required by subsection (a). This result would follow where an increase in taxable income (or a decrease in a net operating loss) of the corporation results from the repeal of sections 452 and 462 which may require an adjustment in the earnings and profits of the corporation and may affect the taxability of distributions of the corporation.

The provisions of subsection (a) may be illustrated by the following example. Corporation X files its income-tax return for the calendar year 1954 on March 15, 1955, and elects under section 6152 of the Internal Revenue Code of 1954 to pay the unpaid amount of the tax shown thereon in two equal installments. Such installment payments are due on March 15, 1955, and June 15, 1955, respectively. In determining its tax liability for such year it elected to avail itself of the benefits of sections 452 and 462. Since corporation X's tax liability for the year 1954 is increased by reason of the enactment of the bill, and since the last date prescribed for paying its tax is before December 15, 1955, it is required to submit a statement or or before December 15, 1955, showing such increase in tax.

Subsection (b) of section 4 corresponds to the same provision of the House bill, with modifications in paragraphs (2) and (3) thereof by committee amendments. Subsection (b) contains provisions relating to the form of the statement required by subsection (a), and the effect of filing such statement. Paragraph (1) of subsection (b) is identical to that of the House bill and provides that the statement shall be filed at the place fixed for filing the taxpayer's tax return for the taxable year to which the statement relates. The statement shall contain the information and computations necessary or appropriate to show the increase in the tax required to be paid as a result of the repeal of sections 452 and 462, and shall be made on a form prescribed by the Secretary or his delegate.

Paragraph (2) of subsection (b) corresponds to the same provision of the House bill with an amendment. Paragraph (2) provides that the amount of increase in tax attributable to the enactment of the bill, as shown by the taxpayer on the statement required by subsection (a), shall be treated for all purposes of the internal revenue laws as though it were a tax shown by the taxpayer on his return. It is provided, however, that an increase in tax for any taxable year attributable to a decrease (by reason of the enactment of the bill) in the net operating loss for a succeeding taxable year, shall not be treated as tax shown on the return.

Paragraph (2) of subsection (b) insures that all provisions of law applicable to the assessment and collection of the tax shown on the return will apply with respect to the amount shown on such statement. One effect of this paragraph is to preclude the imposition of additions

to tax, with respect to such amount, under the pertinent provisions of chapter 68 of the Internal Revenue Code of 1954. Thus, the additions to the tax provided for in section 6653 (relating to additions to the tax for negligence or fraud) will not apply to the amount shown on the statement. Neither this paragraph, nor any other provision of this section, affects any criminal penalty.

Paragraph (3) of subsection (b) is identical to that of the House bill except that the date September 15, 1955, has been changed by amendment to December 15, 1955, in conformity with the change made in subsection (a) of section 4. Paragraph (3) prescribes the conditions under which a period of time will be disregarded in computing interest with respect to the increase in tax. If the taxpayer files the statement in accordance with subsection (a) and pays in full that portion of the increase in tax shown thereon which is due before December 15, 1955, then for the purpose of computing interest (other than interest on overpayments) such amount shall be treated as having been paid on the last day prescribed by law for making such payment.

The provisions of the preceding paragraph may be illustrated as follows:

Corporation X's return for the calendar year 1954 was filed on March 15, 1955, and it paid the tax liability shown thereon in equal installments on March 15, 1955, and June 15, 1955. It filed a statement on December 15, 1955, showing the increase in its tax liability by reason of the repeal of sections 452 and 462 and paid at that time the increase in tax shown thereon. Since the taxpayer has complied with the provisions of paragraph (3), no interest will be imposed with respect to the amount of the payment.

The last sentence of paragraph (3) provides that the paragraph shall not apply if the amount shown on the statement as the increase in the amount of the tax required to be paid for the taxable year is (by reason of the enactment of the bill) greater than the actual increase unless the taxpayer establishes, to the satisfaction of the Secretary or his delegate, that his computation of the greater amount was based upon a reasonable interpretation and application of sections 452 and 462 of the Internal Revenue Code of 1954, as those sections existed before the enactment of the bill.

Subsection (c) of section 4 of the bill is identical with that of the House bill with the exception that there is added a new paragraph (4) and the remaining paragraphs have been renumbered. Subsection (c) provides special rules to give effect to the repeal of sections 452 and 462. Paragraph (1) of subsection (c) is identical with that of the House bill and states that interest shall not be imposed with respect to the amount of any increase in tax resulting from the repeal of sections 452 and 462 for any period prior to the day after the date of enactment of the bill. The provisions of this paragraph are applicable notwithstanding any other provisions of section 4.

Paragraph (2) of subsection (c) is identical with that of the House bill and states the conditions under which additions to the tax will not be imposed with respect to the estimated tax of an individual where additions to the tax would result from the enactment of the bill. Any addition to the tax under section 294 (d) of the Internal Revenue Code of 1939, relating to estimated tax, shall be computed without regard to any increase in tax resulting from the enactment of the bill. In the case of any underpayment of estimated tax to

which section 6654 of the Internal Revenue Code of 1954 applies, any additions to the tax for installments due before December 15, 1955, shall be computed without regard to any increase in tax resulting from the enactment of the bill. Any additions to the tax with respect to installments due on or after December 15, 1955, shall be imposed in accordance with the applicable provisions of the code.

Paragraph (3) of subsection (c) is identical to that of the House bill. Paragraph (3) provides that if—

> (A) the taxpayer is required to make a payment (or an additional payment) to another person by reason of the enactment of the bill, and
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> (B) the Internal Revenue Code of 1954 prescribes a period (which expires after the close of the taxable year) within which the taxpayer must make the payment (or additional payment) if the amount thereof is to be taken into account (as a deduction or otherwise) in computing taxable income for such taxable year,

then (subject to regulations and if made on or before December 15, 1955) the payment (or additional payment) shall be treated as having been made within the period prescribed by the 1954 code. The application of this paragraph may be illustrated by the following examples:

(1) Assume that section 267 of the 1954 code (relating to losses, expenses, and interest with respect to transactions between related taxpayers) applies to amounts accrued by taxpayer A for salary payable to I for the calendar year 1954 if remaining unpaid at the close of March 15, 1955. A is required to pay I a salary equal to 5 percent of taxable income for such taxable year. Under existing law (with the application of sec. 462) the amount accrued and paid for the taxable year 1954 was $5,000. By reason of the enactment of the bill taxable income of A is increased so that the proper accrual for 1954 would have been $6,000. Under paragraph (3) taxpayer A would be entitled to an additional deduction for 1954 of $1,000 if that amount is paid on or before December 15, 1955.

(2) Assume that on March 1, 1955, X, a calendar-year taxpayer on the accrual basis, makes a payment described in section 404 (a) (6) of the 1954 code (relating to contributions of an employer to an employees' trust) of $10,000 which is accrued for 1954 and is required to be paid on the basis of the amount of the taxable income for that year. The taxpayer filed his return April 15, 1955. By reason of the enactment of the bill taxpayer X's taxable income is increased so that he is required to make an additional payment of $2,000. This payment is made before December 15, 1955. By reason of paragraph (3), this additional payment is deemed to have been made on the last day of 1954.

There is added a new paragraph (4) to subsection (c) providing for the treatment of certain dividends paid by a corporation. Paragraph (4) provides that, at the election of a corporation, a dividend paid by such corporation to its shareholders on or before December 15, 1955, may be treated, for purposes of section 561 (a) (1), as having been paid in the prior taxable year under certain circumstances. This rule applies only to the extent dividends paid are attributable to an increase in the taxable income of the corporation for the taxable year to which such dividends are related back and only if such increase results from the enactment of the bill. It applies to those situations where the Internal Revenue Code of 1954 prescribes a period (which expires

after the close of the taxable year) within which a dividend paid may be treated as having been paid in the prior taxable year. This paragraph is subject to such regulations as the Secretary of the Treasury or his delegate may prescribe. Paragraph (4) has no application to dividends paid for taxable years which are not subject to the Internal Revenue Code of 1954.

For example, corporation Y, a personal holding company, for its calendar year 1954 paid dividends to its shareholders on March 14, 1955, in order that it might claim a deduction for dividends paid provided by section 561 (a) (1) for purposes of computing its personal holding company tax. Corporation Y may elect the treatment provided by paragraph (4) with respect to dividends paid to its shareholders for 1954 for purposes of the personal holding company tax but only if all the requirements of paragraph (4) are met. Other corporations which may be entitled to make the election are regulated investment companies and corporations subject to the accumulated earnings tax.

PART VI. CHANGES IN EXISTING LAW

In compliance with subsection 4 of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill are shown as follows (existing law proposed to be omitted is enclosed in black brackets; new matter is printed in italics; existing law in which no changes proposed is shown in roman):

Internal Revenue Code of 1954

CHAPTER 1—NORMAL TAXES AND SURTAXES

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Subchapter C—Corporate Distributions and Adjustments

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PART V—CARRYOVERS

Sec. 381. Carryovers in certain corporate acquisitions.
Sec. 382. Special limitations on net operating loss carryovers.

SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.

(a) GENERAL RULE.—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334 (b) (2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354 (b) (1) are met), or (F) of section 368 (a) (1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

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(c) ITEMS OF THE DISTRIBUTOR OR TRANSFEROR CORPORATION.—The items referred to in subsection (a) are:

(1) NET OPERATING LOSS CARRYOVERS.—The net operating loss carryovers determined under section 172, subject to the following conditions and limitations:

(A) The taxable year of the acquiring corporation to which the net operating loss carryovers of the distributor or transferor corporation

are first carried shall be the first taxable year ending after the date of distribution or transfer.

(B) In determining the net operating loss deduction, the portion of such deduction attributable to the net operating loss carryovers of the distributor or transferor corporation to the first taxable year of the acquiring corporation ending after the date of distribution or transfer shall be limited to an amount which bears the same ratio to the taxable income (determined without regard to a net operating loss deduction) of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(C) For the purpose of determining the amount of the net operating loss carryovers under section 172 (b) (2), a net operating loss for a taxable year (hereinafter in this subparagraph referred to as the "loss year") of a distributor or transferor corporation which ends on or before the end of a loss year of the acquiring corporation shall be considered to be a net operating loss for a year prior to such loss year of the acquiring corporation. For the same purpose, the taxable income for a "prior taxable year" (as the term is used in section 172 (b) (2)) shall be computed as provided in such section; except that, if the date of distribution or transfer is on a day other than the last day of a taxable year of the acquiring corporation—

(i) such taxable year shall (for the purpose of this subparagraph only) be considered to be 2 taxable years (hereinafter in this subparagraph referred to as the "pre-acquisition part year" and the "post-acquisition part year");

(ii) the pre-acquisition part year shall begin on the same day as such taxable year begins and shall end on the date of distribution or transfer;

(iii) the post-acquisition part year shall begin on the day following the date of distribution or transfer and shall end on the same day as the end of such taxable year;

(iv) the taxable income for such taxable year (computed with the modifications specified in section 172 (b) (2) (A) but without a net operating loss deduction) shall be divided between the pre-acquisition part year and the post-acquisition part year in proportion to the number of days in each;

(v) the net operating loss deduction for the pre-acquisition part year shall be determined as provided in section 172 (b) (2) (B), but without regard to a net operating loss year of the distributor or transferor corporation; and

(vi) the net operating loss deduction for the post-acquisition part year shall be determined as provided in section 172 (b) (2) (B).

(2) EARNINGS AND PROFITS.—In the case of a distribution or transfer described in subsection (a)—

(A) the earnings and profits or deficit in earnings and profits, as the case may be, of the distributor or transferor corporation shall, subject to subparagraph (B), be deemed to have been received or incurred by the acquiring corporation as of the close of the date of the distribution or transfer; and

(B) a deficit in earnings and profits of the distributor, transferor, or acquiring corporation shall be used only to offset earnings and profits accumulated after the date of transfer. For this purpose, the earnings and profits for the taxable year of the acquiring corporation in which the distribution or transfer occurs shall be deemed to have been accumulated after such distribution or transfer in an amount which bears the same ratio to the undistributed earnings and profits of the acquiring corporation for such taxable year (computed without regard to any earnings and profits received from the distributor or transferor corporation, as described in subparagraph (A) of this paragraph) as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(3) CAPITAL LOSS CARRYOVER.—The capital loss carryover determined under section 1212, subject to the following conditions and limitations:

(A) The taxable year of the acquiring corporation to which the capital loss carryover of the distributor or transferor corporation is first carried shall be the first taxable year ending after the date of distribution or transfer.

(B) The capital loss carryover shall be a short-term capital loss in the taxable year determined under subparagraph (A) but shall be limited to an amount which bears the same ratio to the net capital gain (determined without regard to a short-term capital loss attributable to capital loss carryover), if any, of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(C) For purposes of determining the amount of such capital loss carryover to taxable years following the taxable year determined under subparagraph (A), the net capital gain in the taxable year determined under subparagraph (A) shall be considered to be an amount equal to the amount determined under subparagraph (B).

(4) METHOD OF ACCOUNTING.—The acquiring corporation shall use the method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary or his delegate.

(5) INVENTORIES.—In any case in which inventories are received by the acquiring corporation, such inventories shall be taken by such corporation (in determining its income) on the same basis on which such inventories were taken by the distributor or transferor corporation, unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of taking inventory adopted pursuant to regulations prescribed by the Secretary or his delegate.

(6) METHOD OF COMPUTING DEPRECIATION ALLOWANCE.—The acquiring corporation shall be treated as the distributor or transferor corporation for purposes of computing the depreciation allowance under paragraphs (2), (3), and (4) of section 167 (b) on property acquired in a distribution or transfer with respect to that part or all of the basis in the hands of the acquiring corporation as does not exceed the basis in the hands of the distributor or transferor corporation.

[(7) PREPAID INCOME.—If the acquiring corporation assumes the liability described in section 452 (e) (2) with respect to prepaid income of a distributor or transferor corporation which had elected, under section 452 (d), to report such income as provided in section 452, the acquiring corporation shall be treated, for this purpose, as if it were the distributor or transferor corporation, unless the acquiring corporation, after the date of distribution or transfer, uses the cash receipts and disbursements method of accounting. In the latter case, the acquiring corporation shall include in gross income for the first taxable year ending after the date of distribution or transfer, so much of such prepaid income as was not includible in gross income of the distributor or transferor corporation under section 452 for preceding taxable years.]

(8) INSTALLMENT METHOD.—If the acquiring corporation acquires installment obligations (the income from which the distributor or transferor corporation has elected, under section 453, to report on the installment basis) the acquiring corporation shall, for purposes of section 453, be treated as if it were the distributor or transferor corporation.

(9) AMORTIZATION OF BOND DISCOUNT OR PREMIUM.—If the acquiring corporation assumes liability for bonds of the distributor or transferor corporation issued at a discount or premium, the acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of determining the amount of amortization allowable or includible with respect to such discount or premium.

(10) TREATMENT OF CERTAIN EXPENSES DEFERRED BY THE ELECTION OF DISTRIBUTOR OR TRANSFEROR CORPORATION.—The acquiring corporation shall be entitled to deduct, as if it were the distributor or transferor corporation, expenses deferred under sections 615 and 616 (relating to exploration and development expenditures, respectively) if the distributor or transferor corporation has so elected. For the purpose of applying the limitation provided in section 615, if, for any taxable year, the distributor or transferor

corporation was allowed the deduction in section 615 (a) or made the election in section 615 (b), the acquiring corporation shall be deemed to have been allowed such deduction or to have made such election, as the case may be.

(11) CONTRIBUTIONS TO PENSION PLANS, EMPLOYEES' ANNUITY PLANS, AND STOCK BONUS AND PROFIT-SHARING PLANS.—The acquiring corporation shall be considered to be the distributor or transferor corporation after the date of distribution or transfer for the purpose of determining the amounts deductible under section 404 with respect to pension plans, employees' annuity plans, and stock bonus and profit-sharing plans.

(12) RECOVERY OF BAD DEBTS, PRIOR TAXES, OR DELINQUENCY AMOUNTS.—If the acquiring corporation is entitled to the recovery of bad debts, prior taxes, or delinquency amounts previously deducted or credited by the distributor or transferor corporation, the acquiring corporation shall include in its income such amounts as would have been includible by the distributor or transferor corporation in accordance with section 111 (relating to the recovery of bad debts, prior taxes, and delinquency amounts).

(13) INVOLUNTARY CONVERSIONS UNDER SECTION 1033.—The acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of applying section 1033.

(14) DIVIDEND CARRYOVER TO PERSONAL HOLDING COMPANY.—The dividend carryover (described in section 564) to taxable years ending after the date of distribution or transfer.

(15) INDEBTEDNESS OF CERTAIN PERSONAL HOLDING COMPANIES.—The acquiring corporation shall be considered to be the distributor or transferor corporation for the purpose of determining the applicability of section 545 (b) (7), relating to a deduction for payment of certain indebtedness incurred before January 1, 1934.

(16) CERTAIN OBLIGATIONS OF DISTRIBUTOR OR TRANSFEROR CORPORATION.—If the acquiring corporation—

(A) assumes an obligation of the distributor or transferor corporation which, after the date of the distribution or transfer, gives rise to a liability, and

(B) such liability, if paid or accrued by the distributor or transferor corporation, would have been deductible in computing its taxable income,

the acquiring corporation shall be entitled to deduct such items when paid or accrued, as the case may be, as if such corporation were the distributor or transferor corporation. A corporation which would have been an acquiring corporation under this section if the date of distribution or transfer had occurred on or after the effective date of the provisions of this subchapter applicable to a liquidation or reorganization, as the case may be, shall be entitled, even though the date of distribution or transfer occurred before such effective date, to apply this paragraph with respect to amounts paid or accrued in taxable years beginning after December 31, 1953, on account of such obligations of the distributor or transferor corporation. This paragraph shall not apply if such obligations are reflected in the amount of stock, securities, or property transferred by the acquiring corporation to the transferor corporation for the property of the transferor corporation.

(17) DEFICIENCY DIVIDEND OF PERSONAL HOLDING COMPANY.—If the acquiring corporation pays a deficiency dividend (as defined in section 547 (d)) with respect to the distributor or transferor corporation, such distributor or transferor corporation shall, with respect to such payments, be entitled to the deficiency dividend deduction provided in section 547.

(18) PERCENTAGE DEPLETION ON EXTRACTION OF ORES OR MINERALS FROM THE WASTE OR RESIDUE OF PRIOR MINING.—The acquiring corporation shall be considered to be the distributor or transferor corporation for the purpose of determining the applicability of section 613 (c) (3) (relating to extraction of ores or minerals from the ground).

(19) CHARITABLE CONTRIBUTIONS IN EXCESS OF PRIOR YEARS LIMITATION.—Contributions made in the taxable year ending on the date of distribution or transfer and the prior taxable year by the distributor or transferor corporation in excess of the amount deductible under section 170 (b) (2) in such taxable years shall be deductible by the acquiring corporation in its first two taxable years which begin after the date of distribution or transfer, subject to the limitations imposed in section 170 (b) (2).

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Subchapter E—Accounting Periods and Methods of Accounting

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PART II—METHODS OF ACCOUNTING

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Subpart B—Taxable Year for Which Items of Gross Income Included

Sec. 451. General rule for taxable year of inclusion.
[Sec. 452. Prepaid income.]
Sec. 453. Installment method.
Sec. 454. Obligations issued at discount.

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[SEC. 452. PREPAID INCOME.

[(a) PREPAID INCOME TO BE EARNED OVER SHORT OR INDEFINITE PERIOD.—

[(1) SHORT PERIOD.—In the case of any prepaid income to which this section applies, if the liability described in subsection (e) (2) is (at the time the income is received) to end before the first day of the sixth taxable year after the taxable year in which such income is received, then such income shall be included in gross income for the taxable year in which received, and for each of the 5 succeeding taxable years, to the extent proper under the method of accounting used under section 446 in computing taxable income for such year. If the liability does not in fact end before the first day of such sixth taxable year, such income shall be included in gross income for the taxable years specified in the preceding sentence except that with the consent of the Secretary or his delegate it shall be included in gross income in such proportions, and for such taxable years, as are specified in such consent.

[(2) INDEFINITE PERIOD.—In the case of any prepaid income to which this section applies, if the liability described in subsection (e) (2) is (at the time the income is received) of indefinite duration, then such income shall be included in gross income for the taxable year in which received and for each of the 5 succeeding taxable years, consistently with the principles prescribed in paragraph (1) and subsection (b), under regulations prescribed by the Secretary or his delegate. With the consent of the Secretary or his delegate the prepaid income shall be included in gross income in such proportions, and for such taxable years, as are specified in such consent.

[(b) PREPAID INCOME TO BE EARNED OVER LONG PERIOD.—In the case of any prepaid income to which this section applies, if the liability described in subsection (e) (2) is (at the time the income is received) to end after the close of the fifth taxable year after the taxable year in which such income is received, then—

[(1) one-sixth of the prepaid income shall be included in gross income for the taxable year in which received, and one-sixth shall be included in gross income for each of the 5 succeeding taxable years; except that

[(2) with the consent of the Secretary or his delegate, the prepaid income shall be included in gross income in such proportions, and for such taxable years, as are specified in such consent.

[(c) WHERE TAXPAYER'S LIABILITY CEASES.—In the case of any prepaid income to which this section applies—

[(1) If the liability described in subsection (e) (2) ends, then so much of such income as was not includible in gross income under subsections (a) and (b) for preceding taxable years shall be included in gross income for the taxable year in which the liability ends.

[(2) If the taxpayer dies or ceases to exist, then so much of such income as was not includible in gross income under subsections (a) and (b) for preceding taxable years shall be included in gross income for the taxable year in which such death, or such cessation of existence, occurs.

[(d) PREPAID INCOME TO WHICH THIS SECTION APPLIES.—

[(1) ELECTION OF BENEFITS.—This section shall apply to prepaid income if and only if the taxpayer makes an election under this section with respect to the trade or business in connection with which such income is received. The election shall be made in such manner as the Secretary or his delegate may by regulations prescribe. No election may be made with respect to a trade or business if, in computing taxable income, the cash receipts and disbursements method of accounting is used with respect to such trade or business.

[(2) SCOPE OF ELECTION.—An election made under this section shall apply to all prepaid income received in connection with the trade or business with respect to which the taxpayer has made the election; except that the taxpayer may, to the extent permitted under regulations prescribed by the Secretary or his delegate, include in gross income for the taxable year of receipt the entire amount of any prepaid income if the liability from which it arose is to end within 12 months after the date of receipt. An election made under this section shall not apply to any prepaid income received before the first taxable year for which the election is made.

[(3) WHEN ELECTION MAY BE MADE.—

[(A) WITHOUT CONSENT.—A taxpayer may, without the consent of the Secretary or his delegate, make an election under this section for his first taxable year (i) which begins after December 31, 1953, and ends after the date on which this title is enacted, and (ii) in which he receives prepaid income in the trade or business. Such an election shall be made not later than the time prescribed by this subtitle for filing the return for such year (including extensions thereof).

[(B) WITH CONSENT.—A taxpayer may, with the consent of the Secretary or his delegate, make an election under this section at any time.

[(e) DEFINITIONS.—For purposes of this section—

[(1) PREPAID INCOME.—The term "prepaid income" means any amount (includible in gross income) which is received in connection with, and is directly attributable to, a liability which extends beyond the close of the taxable year in which such amount is received. Such term does not include any income treated as gain from the sale or other disposition of a capital asset.

[(2) LIABILITY TO RENDER SERVICES, ETC.—The term "liability" means a liability to render services, furnish goods or other property, or allow the use of property.

[(3) RECEIPT OF PREPAID INCOME.—Prepaid income shall be treated as received during the taxable year for which it is includible in gross income under section 451 (without regard to this section).]

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Subpart C—Taxable Year For Which Deductions Taken

Sec. 461. General rule for taxable year of deduction.
[Sec. 462. Reserves for estimated expenses, etc.]

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[SEC. 462. RESERVES FOR ESTIMATED EXPENSES, ETC.

[(a) GENERAL RULE.—In computing taxable income for the taxable year, there shall be taken into account (in the discretion of the Secretary or his delegate) a reasonable addition to each reserve for estimated expenses to which this section applies.

[(b) ADJUSTMENTS WHERE RESERVE BECOMES EXCESSIVE.—If it is determined that the amount of any reserve for estimated expenses to which this section applies is (as of the close of the taxable year) excessive, then (under regulations prescribed by the Secretary or his delegate) such excess shall be taken into account in computing taxable income for the taxable year.

[(c) ESTIMATED EXPENSES TO WHICH THIS SECTION APPLIES.—

[(1) ELECTION OF BENEFITS.—This section shall apply to estimated expenses if and only if the taxpayer makes an election under this section with respect to the trade or business to which such expenses are attributable. The election shall be made in such manner as the Secretary or his delegate may by regulations prescribe. No election may be made with respect to a trade or business if in computing taxable income the cash receipts and disbursements method of accounting is used with respect to such trade or business.

[(2) SCOPE OF ELECTION.—An election made under this section shall apply to all estimated expenses attributable to the trade or business.

[(3) WHEN ELECTION MAY BE MADE.—

[(A) WITHOUT CONSENT.—A taxpayer may, without the consent of the Secretary or his delegate, make an election under this section for his first taxable year (i) which begins after December 31, 1953, and ends after the date on which this title is enacted, and (ii) for which there are estimated expenses attributable to the trade or business. Such an election shall be made not later than the time prescribed by law for filing the return for such year (including extensions thereof).

[(B) WITH CONSENT.—A taxpayer may, with the consent of the Secretary or his delegate, make an election under this section at any time.

[(d) ESTIMATED EXPENSE DEFINED.—

[(1) GENERAL RULE.—For purposes of this section, the term "estimated expense" means a deduction allowable by this subtitle—

[(A) part or all of which would (but for this section) be required to be taken into account for a subsequent taxable year;

[(B) which is attributable to the income of the taxable year or prior taxable years for which an election under this section is in effect; and

[(C) which the Secretary or his delegate is satisfied can be estimated with reasonable accuracy.

[(2) EXCEPTIONS.—The term "estimated expense" does not include—

[(A) any deduction attributable to income taken into account in computing taxable income for taxable years preceding the first taxable year for which the election is made;

[(B) any deduction attributable to prepaid income to which section 452 applies by reason of an election made under such section by the taxpayer; or

[(C) any deduction allowable under section 166 (relating to bad debts).

[(e) SPECIAL RULE FOR DEDUCTIONS ATTRIBUTABLE TO PERIOD BEFORE ELECTION.—Any deduction attributable to income taken into account in computing taxable income for taxable years preceding the first taxable year for which the election is made shall be allowable in the same manner and to the same extent as if this section had not been enacted.]

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