REVENUE ACT OF 1937

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

SEVENTY-FIFTH CONGRESS

FIRST SESSION

ON

H. R. 8234

AN ACT TO PROVIDE REVENUE, EQUALIZE TAXATION
PREVENT TAX EVASION AND AVOIDANCE
AND FOR OTHER PURPOSES

AUGUST 18, 1937

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WEDNESDAY, AUGUST 18, 1937

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

The committee met, pursuant to call, at 10 a. m., in the Finance Committee room, 312 Senate Office Building, Senator Pat Harrison (chairman) presiding.

The CHAIRMAN. Is Mr. McKinney in the audience?

STATEMENT OF HOLT S. McKINNEY, NEW YORK CITY

The CHAIRMAN. How much time do you want, Mr. McKinney?

Mr. McKINNEY. It won't take more than 5 minutes.

The CHAIRMAN. Very well, you may proceed.

Mr. McKINNEY. I represent the Reinsurance Corporation of New York.

The particular subject that I wish to talk about is the exemption of fire-insurance companies under the definition of personal holding companies.

Section 352 of the House bill provides, like section 351 of the present law, that the term "personal holding company" shall not include a bank, life-insurance company, or a surety or casualty company. Fire-insurance companies are included in this exemption. Yet, as a matter of general public policy or national welfare——

The CHAIRMAN (interposing). What page is that on?

Mr. McKINNEY. Section 352, paragraph B on page 3.

Senator KING. You want an amendment by inserting what?

Mr. McKINNEY. After the words "surety company" on page 3, section 352–B, line 4——

Senator KING (interposing). It will be line 9 in the bill.

Mr. McKINNEY. That is right. Line 9; the words "a fire-insurance company."

In the last year, the latter part of 1936, there was organized in this country a new kind of fire-insurance company, and that is the company which is known as the Reinsurance Co. of New York. The business of this company is to reinsure the insurance companies, the direct-writing insurance companies.

Senator KING. Something like Lloyds of Great Britain?

Mr. McKINNEY. That is right. It is in competition with that group.

We submit that the creation of surplus reserves by a fire company is just as important, if not more so, than that of a surety or casualty company.

The business of the Reinsurance Corporation of New York is to reinsure other insurance companies on their excess losses on account of a fire and inland marine risks. This is a new business for American capital, but it is an old business for foreign capital.

It is a remarkable fact that, except for the pioneering efforts of the Excess Reinsurance Association in the fire and allied fields, there is no market or facilities in America for general excess loss reinsurance and no market whatsoever for the necessary reinsurance of the rapidly growing inland marine business.

As a result, a great volume of reinsurance premiums under these headings goes to London whose premium income from these sources is estimated to be considerably in excess of $50,000,000 annually and, if premiums to other foreign sources are included, the total probably exceeds $100,000,000.

In addition to this there is undoubtedly a great potential volume of premium available from companies, who, because under American law, cannot take credit in their financial statements for foreign reinsurance and have either to forego the advantages of excess loss protection or, in the case of inland marine, have not yet developed a sufficient volume of business to enable them to set up the necessary reserves against foreign reinsurance.

In view of this country's enormous financial resources, this dependence on foreign reinsurance is not only in itself remarkable but constitutes a real danger to the insurance activities of this country in that should the obvious economic deline and general unrest in Europe and in another European conflagration, the reactions on the London market and other markets abroad would probably be such as to make it both impractical and undesirable to continue to seek protection there.

If this situation should arise, there is at the present time, with the exception of the Excess Reinsurance Association, no market with the financial or technical ability to meet the emergency; in fact the position is somewhat similar to that which arose after the war when the international discount market was lost to America owing to there being no technical facilities available to undertake the business.

This situation, added to the legal and other obvious disadvantages of reinsuring in foreign nonadmitted markets, is undoubtedly causing American insurance executives to become more and more national-minded in regard to their reinsurance requirements, and there can be little doubt that a vast volume of business awaits the formation of an American market having the financial strength and technical backing necessary to successfully undertake the business.

Senator KING. When did you say it was organized?

Mr. MCKINNEY. In November 1936, the latter part of last year.

Senator KING. Aren't there a number of insurance companies that do insurance marine risks?

Mr. MCKINNEY. Direct-writing companies?

Senator KING. Yes.

Mr. MCKINNEY. Yes, there are; but most of those companies after they take the direct risk, insure with those concerns in Europe.

Senator KING. This company that you refer to is a reinsurance company?

Mr. MCKINNEY. A company to do in the American market what the London companies are doing now.

Senator KING. Is it owned by Americans?

Mr. MCKINNEY. It is owned by Americans, entirely.

The CHAIRMAN. Mr. McKinney, have you ever brought this matter to the attention of the Treasury Department?

Mr. MCKINNEY. No; I have not.

The CHAIRMAN. Doctor Magill, who is Under Secretary of the Treasury, is here, and also Mr. Parker, and I would ask you to have a talk with them about your matter, so that you can inquire about some of these features.

Mr. MCKINNEY. Yes; thank you very much.

The CHAIRMAN. Mr. Harry J. Gerrity.

STATEMENT OF HARRY J. GERRITY, WASHINGTON, D. C.

The CHAIRMAN. You represent the National Association of Building Owners and Managers?

Mr. GERRITY. Yes, Senator.

The CHAIRMAN. And you want about 5 minutes?

Mr. GERRITY. Yes.

The CHAIRMAN. You may proceed.

Mr. GERRITY. Under the existing law, the definition "personal holding company" is any corporation 80 percent or more of whose gross income is derived from dividends, royalties, interests or profit from the sale or exchange of securities. In 1936 and also in 1934 there was an attempt to include as part of the income of personal holding companies, rents, and our association opposed it, and your committee eliminated the word "rents" both in 1934 and in 1936. Also back in 1928 there was an attempt to include the word "rents" as a specific part of the income of a personal holding company.

The CHAIRMAN. Do you object to this provision incorporated in this bill?

Mr. GERRITY. I do not think it gives sufficient protection, and I am suggesting an amendment.

For example, the present bill provides that rents shall be included unless constituting 50 percent or more of the gross income. That is just putting the matter in another way. In other words, under existing law, 100 percent of our gross income was rents, therefore, we feel even the 80 percent provision which says at least 80 percent of the income is in the form of rents there, and now rents are included unless they constitute 50 percent or more of the gross income.

I talked with the tax experts about this matter, and I also appeared before the House Ways and Means Committee, but things are moving so fast, I really do not see any need of putting it in the bill at this time. There will be another revenue bill this year, and the matter might be gone into further then.

The joint committee's report points out that a loophole is permitted whereby an otherwise qualified personal holding company which engages in income-producing real estate under existing law and derives at least 21 percent of its income from rent—therefore they said they did not come in as a personal holding company because 80 percent of their gross income was not in the form of dividends or interest and profit from the sale of stock and securities.

Now, I might point out that that loophole still exists. The hole is still there, but you have just made it a little harder to get through.

The CHAIRMAN. That is what we were trying to do.

Mr. GERRITY. The House report and also your report points out that the income of personal holding companies is mainly investment income, and we stressed heretofore that the operation of an office building is not an investment in the sense that you invest in stocks and bonds or anything like that. It is a going business; you have got an operating staff, you have got to provide for the interest, you have got to provide for taxes and such things, and you run the risk of not getting very much income anyway.

Our association is composed of 48 associations in all the principal cities of the country. Our last vacancy survey report showed something like 2,379 office buildings throughout the United States. Of course, there are a great many large apartment houses owned by corporations, too, and as I pointed out to Mr. Stamm yesterday—he gave me an example of where you have $100,000, we will say, on dividends, and $100,000 from interest and $100,000 from rents, and in that case you would fall under this definition, because your rents would be less than 50 percent of your gross income, but as I said to him, "Suppose you sold one of the buildings of the corporation, and you obtained a large profit? That profit would be part of your taxable gross income, although that profit is not specifically mentioned in the kinds or types of gross income as specified in this section 353."

On the other hand, he pointed out that if you had $10,000 of dividends and $10,000 interest and $30,000 of rents, more than 51 percent of your gross income would be in the form of rents, and therefore this section would not apply at all. If the section would not apply, if your gross income constitutes more than 50 percent in rents, then I think under the existing law the loophole can be stopped up by providing that rents should not be included in determining the gross income of a personal holding company. In other words, it was deliberately left out of the statute.

I cannot see where the loophole exists if the Treasury Department would consider giving the statute the intention that Congress had in mind. Rents should have been disregarded in determining personal holding company gross income.

We have had reports as to another requirement as to the definition of personal holding companies, that it shall have five or less stockholders, this statutory definition, and this is just a partial report which I have received this morning covering 66 office buildings in Chicago, Indianapolis, Milwaukee, Buffalo, and probably 18 or 20 cities, 16 of which have five or more stockholders, and 34 have five or less stockholders.

That is not what you are after as to the personal holding companies. The title to an office building or an apartment is held in corporate form wholly for convenience. It is business; they have all of the risks of any other business.

And I might also read from a telegram which the San Francisco association of building owners and managers sent me this morning. They object to the inclusion of the word "rents" because the percentage of gross income specified to consist of rents is much too high. They say—

Many of our members are purely and legitimately operating a real-estate corporation, some of whom will be injured if 50 percent of their gross income must constitute rents. We strongly urge amending section G to reduce largely the percentage of rents required.

I just think rents should be eliminated. You are going to cause yourselves a lot of trouble. The Treasury is going to have a deuce of a time administering this provision. It is going to give rise to all kinds of controversy with revenue agents and things of that kind, and the House committee report and this committee has gone on record last year and also in 1934 that you do not want to injure bona fide real-estate corporations that are engaged in a regular operating business.

Senator BULKLEY. How many bona fide real-estate corporations are there that have less than 50 percent of their income from rents?

Mr. GERRITY. That we do not know, Senator. We are making a complete canvass of some 2,379 office buildings in order to determine which of those consist of five or less stockholders, and presumably at least 80 percent of their revenue being in the form of rents.

Senator BULKLEY. Then you are not affected at all?

Mr. GERRITY. Except that when you come to this point of rents and interests. Another Congress might increase the percentage. Instead of 50 percent, they might increase it to 90 percent.

Senator BULKLEY. That is pretty speculative.

Mr. GERRITY. In that event you will be getting these companies in.

Now, in order to clarify the matter, and I want to strengthen it and help the committee, if there is a loophole I think it ought to be stopped up, but I do not think you are doing it in this way, and you are just storing up a lot of trouble for the Treasury Department and also for the committee later on.

The CHAIRMAN. The Treasury Department is inviting it. The Department is the one that makes this recommendation.

Mr. GERRITY. But on three previous occasions this committee has gone on record as considering rents as not a proper type. In other words, personal holding company income under the new bill is defined. You refer to another section. It is just a new approach to the matter of personal holding company income, but personal holding company income is mainly unearned income, dividends which are net income, interest which is net income, a profit from the sale of stock or securities or the exchange thereof. It is net. But rents, when you use the word "rents" you mean gross rents. It is the receipts.

Now, what do the rents represent? They represent the sale price of property, the space that is leased, and in addition, the service that is rendered in a building to the occupant of that space, which is all operating expense.

Senator BULKLEY. It might represent that, but it might be income under a 99-year lease, where there was nothing of that kind at all.

Mr. GERRITY. That is clearly unearned income and we have no objection to your getting after people who get income from net rents.

I am suggesting that on page 5, line 14, of the bill, if the word "rents" is still included, that there be inserted after the word "income" under subsection F:

or the gross income of any corporation whose principal business consists of the ownership, operation, or management of office buildings, apartment houses, or other commercial income-producing real estate.

I believe that that would be a clarification; that would be a recognition, as the House committee report and as this report has said, that you seek to protect bona fide real-estate corporations, so that even if

you speak of rents you do not speak of rents of a corporation or a business whose principal business is the ownership, operation, or management of office or apartment house buildings.

The CHAIRMAN. All right; thank you, Mr. Gerrity.

Senator DAVIS. Mr. Chairman, there must be some misunderstanding about this, and I would like to read a letter or a telegram into the record. It is very short; it is addressed to me here, from Philadelphia; it is as follows:

H. R. 8234 containing word "rents" in defining personal holding companies grossly unfair and unjust to real-estate corporations owning and operating office and apartment buildings. Strongly urge that paragraph G of section 353 covering rents be completely eliminated in justice to bona fide real-estate corporations.

FIFTEENTH & CHESTNUT REALTY CO.,
MAURICE BOWER SAUL, *President.*

The CHAIRMAN. I do not think there is any misunderstanding about this proposition at all. Have you any comment to make, Mr. Kent?

STATEMENT OF ARTHUR H. KENT, ASSISTANT GENERAL COUNSEL, TREASURY DEPARTMENT

Mr. KENT. The only misunderstanding that seems to be abroad appears to be that merely because a corporation gets less than 50 percent of its gross income from rents, it is automatically made a personal holding company. Of course, that is not true. If a corporation gets 49 percent of its income from rents, it must still get an additional 31 percent of its gross income from dividends, interest and other sources in order to meet the test of a personal holding company.

We have considered very carefully Mr. Gerrity's argument presented before the House Ways and Means Committee, and I am frank to say that I have great difficulty in understanding Mr. Gerrity's ideas. Mr. Gerrity makes the argument, for instance, that, because it is possible under the existing law for a company to get out of the personal holding company classification by deriving 31 percent of its income from rents, the same loophole exists under the proposed bill because it gets out of the personal holding company classification by deriving 51 percent of its gross income from rents.

Well, it seems to me it is quite obvious there is a difference, quite a difference, in the size of the loophole if all they have to do is get 21 percent on the one hand or they have to get 51 percent on the other.

Mr. Gerrity has argued that the proposed provision would be difficult of administration. I should say that it would be simple of administration as compared to his proposal which would make the test of exclusion depend upon a vague provision that the principal operation or activity of a corporation was the ownership or management of real estate. We would be in court on almost every case, I am afraid, if anything of that sort were written into the law.

What we tried to do was to establish a fair test to separate these corporations which were bona fide real-estate operating corporations from those which were not, and we felt that the 50-percent criterion was a perfectly fair test from that point of view. I cannot see why a corporation formed to own an apartment house or an office building should be carrying a tremendous portfolio of investment securities. If any such companies exist at the present time, they can easily avoid their difficulties by separating their functions of invest-

ing in stocks and securities from the function of owning and operating that building.

We are not aiming at those corporations which are bona fide engaged in the operation of commercial real estate. So far as Mr. Gerrity's suggestion that it should be net rents rather than gross rents, which should be included, we have examined that suggestion and in every case that we have been able to think of, his suggestion would work contrary to the interests of the very people that he is representing.

Senator BROWN. Mr. Chairman, in view of that statement, I would like to put into the record a telegram from the Building Owners & Managers Association of Detroit.

The CHAIRMAN. Yes.

(The telegram referred to above is as follows:)

Hon. PRENTISS BROWN,
United States Senate, Washington, D. C.

This association representing practically every important Detroit office building aggregating in value a hundred and fifty million dollars strongly urges the complete elimination of paragraph G of section 353 of tax bill H. R. 8234 now before Congress which we fear will pass House unchanged. We ask this for the protection of bona-fide real-estate companies in our group and for the same reasons specified in our contentions of 1934 and 1936 when the same objectionable features in the proposed bills were eliminated.

BUILDING OWNERS & MANAGERS ASSOCIATION OF DETROIT,
HARRY W. THOMAS, *Executive Secretary,*
1160 National Bank Building.

The CHAIRMAN. Mr. George M. Morris.

STATEMENT OF GEORGE M. MORRIS, WASHINGTON, D. C.

The CHAIRMAN. You represent the American Bar Association, Mr. Morris?

Mr. MORRIS. No, sir; I am speaking for no one but myself. I have also received a number of letters from other lawyers. I happen at present to be chairman of the house of delegates of the American Bar Association, but I have no authority to represent them here.

I wish to appear before the committee and call attention to pages 31 and 32 of the bill, which is an amendment of section 340, the Revenue Act of 1936, and which comes into this bill under the guise of section 201. That is the section which requires any attorney or lawyer in this country who has formed, assisted, aided, or counseled in the formation or reorganization of a foreign corporation since December 31, 1933, to report to the Commissioner of Internal Revenue; or who may hereafter aid, counsel, or assist in the formation of a foreign corporation or its reorganization, to report within 30 days to the Commissioner of Internal Revenue.

The reason for protesting is that this proposal violates the fundamental ethical requirements of the practice of the law; namely, that no lawyer shall disclose any information received by him through his professional employment by a citizen or a litigant or anyone seeking legal advice.

The effect of this provision is to enroll approximately 175,000 lawyers in this country as telltales for clients who have formed foreign corporations, regardless of whether they have any relation to taxes in anywise whatever.

There was a provision added, or rather put into the bill by the House after the recommendation of the joint committee, which read that—

Nothing in this section shall be construed to require the divulging of privileged communications between attorney and client.

To the casual observer, that might be a curative sentence. As a matter of fact, it does not work that way so far as the real fundamental principle is concerned.

The gentlemen of the committee will recall that a lawyer by the ethics of the profession is forbidden to accept employment in any situation where a disclosure of information received by him from his client will be required. That has been a fundamental principle of public policy for centuries, long before we had any government in this country, and that has been recognized as a sound public principle.

Now, what the bill does is to recognize not that principle but a mere rule of evidence. The rule of evidence is that a lawyer shall not be required to disclose the privileged communications from his client. When the question is asked him, he can make that answer. When the question is asked him, he has the protection of the judge and the court, he has the protection of opposing counsel. In this proposal in this bill he has no protection from anybody; he is simply required to make a return directed by the Commissioner of Internal Revenue, unless in the opinion, apparently of the lawyer himself, the making of the return is the divulging of a privileged communication. What constitutes "privileged communication" will differ in every State in this country, so therefore this permits, as I see, no withholding at all except in the opinion of the individual who withholds making the return.

Because section 340 violates this fundamental concept, I suggest the elimination entirely of this section.

May I continue a moment further? I would like to talk for a moment as a man who has paid some attention to taxes, and I wish to say about this section, that if I did not have the high regard for the brilliant ability and wisdom of the expert assistants of the committee and of the House committee who are gathered around me here in handsome array, I would say that this provision was absolutely naive. Note what it says. It says that a lawyer who is subject to the jurisdiction of the United States if he aids, assists, and counsels in the organization or reorganization of one of these foreign corporations has to report. But what about the lawyer who is resident in Montreal or the Bahamas or Nassau, or any of these other places where all of this difficulty about these fly-by-night organizations has arisen? You have no jurisdiction over him at all.

What is the effect? If what you are trying to do is to get this mere handful of sharpers and "taxperts" who are giving this advice to form these tricky foreign corporations, you do not catch them by this device. Admittedly, that is all this is designed for.

Why won't you catch them? Well, all that they will have to say to a man who wants to organize one of these companies is, "If you take a train this afternoon at 4:50 o'clock, you can get to Montreal tomorrow morning and there you can go and see my correspondents, Jones, Smith & Brown, and they can give you any advice that you want about personal holding corporations, but I cannot, because if I do, I will have to report it."

That is the simplest method of evasion of this whole thing which would occur to a child. A reputable lawyer will do exactly the same thing. If a man came to me and said, "I want to form one of these personal holding companies abroad," I would say, "If I give you any advice on this, I will have to report to the Commissioner of Internal Revenue. That may be embarrassing to you. If you are going to do that you had better see some lawyer who is not amenable to the jurisdiction of the United States. There are many lawyers of that kind in Canada, in the Bahamas, in many of these foreign jurisdictions, and you can have them form your personal holding company through them."

Senator BROWN. You will admit that there are a few in the United States, too, don't you?

Mr. MORRIS. Yes, they are the ones we are trying to catch, but you won't catch them with this device. Nobody who is sensible, nobody who has any sense of patriotism at all wants to see a statute that is not enforced. We are all taxpayers; every man at this table is a taxpayer; every man in the room is probably a taxpayer. We do not care to see other people not paying their fair share of the taxes. I am not for a moment protesting against the purposes of this bill; I am simply saying that if this provision is left in here, we violate a fundamental concept of all free government, the relation of a lawyer to his client as no. 1; and, no. 2, it will not accomplish the purpose it is designed to accomplish and get at; and, no. 3, never has the Commissioner of Internal Revenue or the Treasury Department asked the taxpayers in their returns whether or not they have formed foreign corporations, whether or not they have received any dividends from them. Until the request is made of taxpayers for that information, what possible assurance is there that they won't give it themselves?

Consider this situation: You are presented with a blank of an income-tax return, and it says to you as a taxpayer, "Do you hold any stock in a foreign corporation or a foreign holding corporation?" Also, "Have you formed a foreign corporation?"

You are going to answer that return under oath as a taxpayer. Are you going to say, "No", if you have? No matter what your own moral code is, are you going to take a chance of a criminal prosecution by saying, "No", if you have done those things? The number of men in this country who will do that, who are substantial taxpayers, must be practically nil if only for the pragmatical value of answering that kind of a question correctly.

Until that is done, why violate a principle that is fundamental with us? Why violate a principle that is historical in the profession? Why violate a principle that has been recognized for centuries? You do not take an elephant gun to clear out a flock of mosquitoes. You do not burn down a house to get the rats that are in it.

Gentlemen, before any such principle as this is incorporated in legislation, careful attention should be given to what you are really overthrowing, because remember this, when you are out of office, if this is a good precedent, any public officer can be required to turn to the bar of this country and say, "Report to us what your clients said to you on such and such a date; report to us what your clients did on such and such a date." If that is good, sound, public policy, it can be carried to any length.

I suggest the omission of this section and to let stand that section which does require, and properly, every taxpayer to report the relationship he has to these personal holding companies or these foreign corporations.

Senator BARKLEY. Don't you think that to a certain extent members of the bar are just as much public officers and charged with as much public responsibility as men who happen to hold elective or appointive offices?

Mr. MORRIS. Yes, and that is the reason I am here.

Senator BARKLEY. What is the objection to requiring these public officers to have some concern for the conduct of their clients who may be engaged in this evasion process?

Mr. MORRIS. I think every public officer has great concern for about counseling evasion by clients, and if you could listen to the ordinary advice given in a tax lawyer's office, I think you would agree with me on that. But, to answer your question the other way, the objection is because the lawyer divulges information which he receives in a confidential relationship to his client, and that is a fundamental rule which goes to the very basis of a lawyer and client relationship, and which has been recognized for centuries as sound public policy.

The CHAIRMAN. Thank you, Mr. Morris.

The committee will now go into executive session.

(Whereupon, at 11 a. m., the hearing was closed and the committee went into executive session.)