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REVENUE ACT OF 1964

REPORT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

TO ACCOMPANY

H.R. 8363

A Bill To Amend the Internal Revenue Code of 1954 To Reduce Individual and Corporate Income Taxes, To Make Certain Structural Changes With Respect to the Income Tax, and for Other Purposes

TOGETHER WITH

Individual and Minority Views

JANUARY 28, 1964.—Ordered to be printed

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Calendar No. 805

88th Congress, 2d Session — SENATE — Report No. 830

REVENUE ACT OF 1964

January 28, 1964.—Ordered to be printed

Mr. Long of Louisiana, from the Committee on Finance, submitted the following

REPORT

Together with

INDIVIDUAL AND MINORITY VIEWS

[To accompany H.R. 8363]

The Committee on Finance, to whom was referred the bill (H.R. 8363) to amend the Internal Revenue Code of 1954 to reduce individual and corporate income taxes, to make certain structural changes with respect to the income tax, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. SUMMARY

This bill, H.R. 8363, the Revenue Act of 1964, provides $11.6 billion of tax reduction scheduled over a 2-year period, the bulk of the relief, however, becoming effective within a month of enactment. The bill will cut back on excessive tax rates which unnecessarily restrain individual and business incentives, it will provide the increased consumer and business purchasing power to assure continued expansion, and it will improve the equity of the tax system.

(*a*) ***Revenue.***—The bill when fully effective in 1965 will reduce tax liabilities of individuals by $9.2 billion and of corporations by $2.4 billion. At constant income levels the bill would reduce receipts by $1.9 billion in fiscal year 1964 and $8.4 billion in fiscal year 1965 (including the $1.9 billion reduction from 1964). Taking into account the effect of this reduction in increasing private expenditures and income, the net effect on revenues is expected by the Treasury Department to be a reduction of $1.7 billion in fiscal year 1964 and $4.3 billion in fiscal year 1965.

(*b*) ***Rate reduction.***—

1. ***Individual.***—As in the House bill, individual rates are reduced from the present range of 20 to 91 percent to a new range of 16 to 77 percent in 1964 and to 14 to 70 percent in 1965. The bill provides that the withholding rate, presently 18 percent, will be reduced to 14 percent, effective within a week after enactment.

2. ***Corporate rate.***—As in the House bill, the tax rate for corporations in 1964 is reduced from 52 to 50 percent and is further reduced in 1965 to 48 percent. In addition, the rate applicable to the first $25,000 of corporate income beginning in 1964 is reduced from 30 percent to 22 percent. Furthermore, corporations are placed on a full pay-as-you-go basis so that ultimately all of their tax liability above $100,000 is to be payable in the year in which it is earned. This is achieved over a 7-year period so that it will not increase corporate cash outlays for tax payments in any year of the transitional period.

(*c*) ***Structural changes.***—In addition to rate changes the bill provides a number of provisions designed to increase the equity of the present tax law. Some of these increase and others decrease the revenue. The major items are:

1. ***Minimum standard deduction.***—The bill provides that each taxpayer may have a minimum standard deduction of $300 plus $100 for each additional exemption. This relieves from tax all single individuals with incomes up to $900, and all married couples with incomes up to $1,600.

2. ***Dividend credit and exclusion.***—The 4-percent dividend received credit is reduced by the bill to 2 percent for 1964, and repealed for subsequent years. The $50 dividend exclusion is increased to $100 for 1964 and subsequent years. In practical effect, this increase is from $100 to $200 for married couples.

3. ***Retirement income credit.***—The bill provides that in computing the retirement income credit the limit on retirement income is to be raised from $1,524 to $2,286 in certain cases where a joint return is filed.

4. ***Investment credit.***—In the case of the investment credit, the bill (*a*) repeals the provision requiring a 7-percent downward adjustment in the basis of property eligible for depreciation to the extent that the investment credit applies; (*b*) prevents regulatory commissions in certain cases from requiring the "flowthrough" of the benefits of the investment credit to the customers of regulated industries; and (*c*) makes other revisions in the investment credit.

5. ***Group term insurance.***—The bill limits the employee exclusion for premiums on group term insurance furnished through the employer to premiums paid for the first $70,000 of coverage.

6. ***Sick pay exclusion.***—The bill restricts the sick pay exclusion, of up to $100 a week, only to those who are absent from work for more than 30 days (and makes the exclusion available only for the period beyond that time).

7. ***Sale of residence by aged taxpayer.***—The bill provides an exclusion from the tax base for the gain attributable to the first $20,000 of the sales price of a personal residence in the case of an individual aged 65 or over.

8. ***Deduction of certain State and local taxes.***—The bill denies a deduction in computing income subject to Federal tax for State and

local taxes other than property, income, general sales taxes, gasoline, and auto license (the principal taxes for which a deduction is denied are alcoholic beverage, cigarette, and selective excise taxes).

9. ***Casualty loss deduction.***—The deduction for personal casualty and theft losses is limited to the amount in excess of $100 per loss (similar to "$100 deductible" insurance).

10. ***Charitable contribution deduction.***—Several changes are made in the charitable contribution deduction: (*a*) The 30-percent maximum deduction is made available generally for contributions to publicly supported organizations other than private foundations; (*b*) the 2-year carryover of charitable contributions for corporations is extended to 5 years; (*c*) a 5-year carryover is provided for individuals with respect to contributions to publicly supported organizations; (*d*) the unlimited charitable deduction is restricted to contributions to publicly supported organizations; and (*e*) charitable contributions deductions for future interests in tangible personal property are denied until the gifts are completed.

11. ***Foreign expropriation losses.***—The bill permits a taxpayer which has sustained a substantial foreign expropriation loss after 1958 to carry over that portion of a net operating loss arising from the foreign expropriation loss for 10 years without any carryback.

12. ***Medical expense deduction.***—The 1 percent limitation, or floor, on medicines and drugs which must be taken into account in determining deductible medical expenses is made inapplicable where the taxpayer or his wife is over 65 and also with respect to such expenses for dependent parents over 65.

13. ***Child-care expense deduction.***—The child-care deduction is revised (*a*) to make it available in the case of a wife who is incapacitated; (*b*) to make it available with respect to care for children up to age 13 (instead of 12); (*c*) the maximum deduction allowable where there are two or more children is increased from $600 to $900, and to $1,000 where there are three or more children; and (*d*) the present limit on the family income in the case of a working wife is raised from $4,500 to $7,000.

14. ***Moving expense deduction.***—A deduction for certain moving expenses—transportation of the household goods and the persons involved, and also their meals and lodging while in transit—is allowed for employees who are not reimbursed for these expenses and also for new employees (an exclusion for these items is already available in the case of old employees who are reimbursed). Old employees who are reimbursed for certain costs and losses in connection with the sale of their old home, occasioned by a move, are permitted to treat the reimbursement as sale proceeds rather than compensation.

15. ***Political contribution deduction.***—The bill allows individuals a deduction, limited to $50 a year ($100 on a joint return) for contributions to any political candidate or political committee to further the candidacy of individuals.

16. ***Intercorporate dividend deduction for certain affiliated groups.***—The bill provides that certain affiliated groups eligible to file a consolidated return, but not doing so, may take under certain conditions a 100-percent deduction for intercorporate dividends received from other members of the group if the group agrees to be treated as a single entity for certain purposes, such as the surtax exemption.

17. ***Face amount certificate companies.***—The bill provides that a "face amount certificate company" shall not be subject to disallowance of a deduction on interest paid with respect to face amount certificates under section 265(2) of the code (relating to interest indebtedness to carry tax-exempt bonds on tax-exempt income) to the extent that tax-exempt obligations do not constitute more than 25 percent of the average of the total assets.

18. ***"Bank loan" insurance.***—An interest deduction is denied for amounts borrowed under a systematic plan to pay premiums on life insurance (certain exceptions are provided).

19. ***Corporate reorganizations.***—The bill provides tax-free status to a stock-for-stock reorganization, where the corporation acquiring the stock exchanges either its voting stock or the voting stock of a corporation which is in control of the acquiring corporation.

20. ***Travel expense deduction.***—The bill repeals the rule, adopted in 1962, which disallows a portion of travel expenses for certain business trips which are combined with a vacation.

21. ***Pension plans.***—The bill permits retroactive qualification for certain pension plans under multi-employer collective bargaining agreements. It also permits a U.S. corporation to extend coverage under its qualified pension, profit sharing, etc., plan to certain U.S. citizens employed by subsidiaries operating outside of the United States.

22. ***Stock options.***—The present tax treatment of employee stock options is further restricted, the principal additional restrictions being: (*a*) the stock when acquired must be held for 3 years or more; (*b*) the option must not be for a period of more than 5 years; (*c*) the option price must at least equal the market price of the stock when the option is issued; (*d*) stockholders' approval for the options must be obtained; and (*e*) the extent to which new options may be exercised when the old options are outstanding is restricted. Separate tax treatment is provided for employee stock purchase plans which are available to all employees on a nondiscriminatory basis under rules which are substantially the same as under present law.

23. ***Installment method.***—The bill treats all revolving credit sales as installment sales for tax purposes and also treats time payment charges as installment sales.

24. ***Deduction of contested liabilities.***—The bill would allow a deduction for the taxable year in which a taxpayer pays a tax or other liability, even though he contests the liability.

25. ***Interest on certain deferred payments.***—Where property is sold on an installment basis and either no, or very low, interest is charged on the installments, the bill provides that an appropriate amount of each installment is to be treated as if it were an interest payment.

26. ***Personal holding companies.***—The percentage of passive income which may result in a company being classified as a personal holding company is reduced from 80 to 60 percent and amendments are made so that the tax cannot be avoided by using rental income or oil or gas or mineral royalties (or working interests) to shelter substantial amounts of investment income, such as dividends and interest, from the personal holding company tax. Other restrictive amendments are also made. Relief is provided for those companies which are not now personal holding companies, but which would be

under the new definitions. They are permitted favorable liquidation treatment in certain cases and also permitted a deduction, in computing the personal holding company income, for paying off existing debts.

27. ***Aggregation of oil and gas properties.***—For the future, oil and gas leases or acquisitions are no longer to be aggregated in determining what constitutes a property for purposes of computing the percentage depletion deduction.

28. ***Iron ore royalties.***—The bill provides capital gains treatment for certain domestic iron ore royalties.

29. ***Life insurance companies.***—The bill makes three changes with respect to the income tax of life insurance companies: (1) It removes the requirement of present law that life insurance companies, and mutual insurance companies electing to be taxed on investment income only, are to ratably accrue market discount on purchased bonds as ordinary income; (2) it extends to 1962 the rule for deductibility of certain distributions to shareholders pursuant to certain mutualization plans; and (3) it assures deductibility of qualified pension plan contributions of mutual insurance companies.

30. ***Regulated investment companies.***—The bill amends the regulated investment company provisions (1) by increasing from 30 to 45 days after the close of the taxable year the time for giving certain notices to shareholders, and (2) by providing that distributions by a unit investment trust liquidating an individual's interest are not to be considered as giving rise to capital gains tax with respect to interests of other investors still in the trust.

31. ***Foreign tax credit on mineral operations.***—The bill provides that any excess foreign tax credit which arises from mineral extraction, because of the percentage depletion allowance under U.S. law, may not be used to offset U.S. tax on income not related to mineral extraction, processing transportation or marketing.

32. ***Sale of depreciable real estate.***—In the case of real estate sold in the future, any depreciation deductions, generally to the extent these deductions exceed depreciation allowable under the "straight line" method (to the extent of the gain), will be treated by the bill as giving rise to ordinary income. However, in the case of property held more than 20 months the amount treated as ordinary income will be reduced by 1 percent for each month of holding over 20, with the result that no amount will be treated as ordinary income in the case of real property held more than 10 years.

33. ***Averaging of income.***—The bill in effect provides for the averaging of income over a 5-year period where the income in the current year exceeds the average of the 4 prior years by more than one-third and this excess is more than $3,000.

34. ***Subchapter S corporations.***—The bill amends the provisions for subchapter S corporations to provide (1) that certain distributions of money made after the close of a taxable year may be treated as made at the close of that year in order to prevent double inclusion of income, and (2) that a corporate member of an affiliated group may elect subchapter S treatment where the only other members of the group are inactive subsidiary corporations.

35. ***Repeal of consolidated returns tax.***—The 2-percent penalty tax, which must presently be paid by corporations for the privilege of filing consolidated returns, is repealed.

36. ***Multiple surtax exemption.***—For corporations where there is common control to the extent of 80 percent or more, the corporations involved generally are limited to one $25,000 surtax exemption for the group or alternatively required to pay a special tax of 6 percent on the first $25,000 of their income. No penalty tax is imposed where a consolidated return is filed for the group.

37. ***Tax lien on automobiles.***—A purchaser, mortgagee, or pledgee of a motor vehicle will not be subject to a Federal tax lien against the motor vehicle, notice of which has been publicly filed, unless the purchaser, mortgagee, or pledgee had actual knowledge of the existence of the lien.

II. GENERAL STATEMENT

H.R. 8363 represents a basic revision of the Federal income tax laws. By substantially reducing individual and corporate tax rates, it is anticipated that this bill will stimulate higher investments and increase consumer purchases. In this manner, the bill is designed to lessen unemployment and to increase the rate of growth of our productive capacity. The bill also contains a series of structural changes in the tax system designed to improve the equity of the system and to close loopholes.

The extensive public hearings held by your committee have provided convincing evidence of the wide area of agreement on the part of the public generally—including representatives of both business and labor—of the need for reducing our present unrealistically high individual income tax rates. At present, they range from 20 to 91 percent and under this bill are reduced to a range of 14 to 70 percent. Also in the case of corporations, by reducing the top rate from 52 to 48 percent, this bill converts the Government from a "senior partner" to a "junior partner" in any business undertaking. The present high income tax rates are a carryover from the tax policy of World War II and the Korean war when the dampening down of investment stimulants and holding the line on consumption were necessary to our wartime effort. These policies are no longer appropriate, however, in our economy today.

Despite the fact that business conditions have been improving over the past 33 months, unemployment still is at the high rate of 5.5 percent, which matches the unemployment rate in the 1954 recession. Since obtaining an unemployment rate of 4.2 percent in 1956, we have experienced a succession of disappointing recoveries in which the unemployment rate has remained disturbingly high; this rate, in fact, has not been below 5 percent since 1957.

Added significance for this persistent high rate of unemployment lies in the fact that the next decade will be a period of unusually high growth in the labor force as the children of the post-World War II era come of age. The annual growth in the labor force as a result can be expected to increase from less than 1 million to about 1¼ million. In addition, it is expected that with an improvement in employment conditions, perhaps 1 million people not now seeking work will return to the labor market. This shows quite clearly that the growth rate of our economy must be increased if the requisite jobs are to be found for this expanding labor force.

Although business conditions were generally good in 1963, the level of new investment in business plant and equipment was scarcely 6 percent above the level of investment in 1957, despite the 31-percent increase in the gross national product during this period.

The existence of these underutilized resources of manpower and plant capacity means that it is possible to attain a faster economic growth through tax reduction without significant inflationary pressures. The 5-year stability of the wholesale price index, together with the relatively moderate increase in the consumers' price index, in recent years, is evidence of this. The goal of a balanced growth with stable prices will, of course, also call for restraint in Government expenditures.

Tax reduction is also important as an aid in the reduction of our persistent balance-of-payments deficit. The presence of greater investment incentives and opportunities abroad than at home is the root cause of American capital seeking foreign outlets. The expanding markets resulting from the tax reduction contained in this bill will raise the attractiveness of domestic investment. Moreover, a faster domestic growth rate will result in a larger flow of new products and technological improvements, making our exports more competitive. The substantial improvements in our balance-of-payments position in the last 6 months is further evidence that an improvement in domestic business can aid our foreign balance. This also has been the experience in Europe where is is the rapidly growing and modernizing economies that have strong currencies.

(a) Tax reduction and revenues

The record of economic performance below capacity over the last 6 years has left a heavy mark on the Federal debt. The initial budget forecast for each of the fiscal years 1958-63 was for a budgetary surplus. The actual outcome in 5 out of the 6 years was a deficit with the deficit averaging about $5 billion.

The major factor in each of these deficits was the failure of the economy to expand as predicted. Either the present or proposed tax rates are high enough to produce a substantial budgetary surplus in a few years if there is sufficient growth and the economy operates at a high level. The present rates, however, constitute such a drag on the economy that the rate of growth has been disappointing and the rate of operation remains low. As a result, income and profits are relatively low and tax receipts are lower than would otherwise be the case. This is the principal factor accounting for the budgetary deficits.

The size of tax receipts is attributable to two variables, the tax rates and the tax base. The major thrust of the present tax bill is to provide a long-range expansion in one of these variables—the tax base—and thereby to increase the revenue potential. To accomplish this result the bill encourages the expansion of the private, rather than public, sector of the economy.

The present tax bill, along with a policy of expenditure constraint offers promise of restoring a balanced budget by the fiscal year 1967 or 1968. During a year of healthy growth in our economy the yield of the present tax system will increase in the neighborhood of $5 billion to $6 billion. The reduction in tax rates under this bill is designed to maintain that high rate of growth which will provide

sufficient additional revenue to cover the cost of the tax bill in a relatively short period of time.

It may be argued that taxes should not be cut while there is a budget deficit. However, this overlooks the fact that maintaining high tax rates does not produce more revenue unless the tax base expands sufficiently—and the rates themselves inhibit this expansion. It is your committee's considered judgment that with the current rates it would take longer to eliminate the deficit than would be the case with the lower rates of this bill but with the expanded economy induced by this bill.

(b) Expenditure control

The House bill in section 1 contains a statement of policy as to the need to stimulate the economy and in this manner raise revenues. It also states that to further the objective of obtaining balanced budgets in the near future, Congress by this action, recognizes the importance of taking all reasonable means to restrain Government spending and urges the President to declare his accord with this objective.

The accord of your committee with the first of these statements is evidenced by its approval of the tax reduction provided by this bill and in the views expressed above that this legislation will, in the long run, increase rather than decrease revenues.

Your committee is also in accord with the second of these statements. The fact that your committee is reporting this bill after the presentation of the President's budget for the fiscal year 1965 is fortunate in that now the restraint of Government spending not only has been stated as an objective of administration policy but also is evidenced by the budgetary figures themselves. This budget reduces the deficit in the administrative budget by more than one-half from $10 billion to $4.9 billion. It also reflects a substantial decrease in new obligational authority requested and actually provides for a slight reduction—from $98.4 billion to $97.9 billion—in the level of spending for the fiscal year 1965. In view of these considerations, your committee believed that the retention of section 1 of the House bill was unnecessary. Moreover, it is questionable whether expressing declarations of intent in tax legislation would be a desirable precedent. Intent to restrain Government expenditures can best be evidenced by action on appropriation bills as they are presented in this session of Congress.

(c) *The structure of tax reduction*

This bill provides a balanced reduction between individuals and business firms. In this respect, the bill is much the same as the bill that came from the House. When fully effective, the bill will reduce individual income taxes by $9.2 billion and will reduce corporate taxes by about $2.4 billion. These figures must be evaluated along with the effective tax reduction of 1962 through the investment credit and depreciation reform, the largest share of which went to corporations. Taking the 1962 and 1964 programs together, the share of the reduction going to individuals is about two-thirds and to corporations about one-third, which is approximately the present relative shares of individuals and corporations in income tax liabilities.

Looked at another way, the net individual income tax reduction will reduce present tax liabilities for individuals by just under 20 percent. The combined effects of this bill, depreciation reform, and

last year's investment tax credit, will reduce corporate tax liabilities by something more than 19 percent.

The bill equitably distributes tax reduction over the various individual income tax levels. Those at the lowest income levels will receive the largest tax reductions, measured as a percent of the present tax. This reduction of 38.6 percent of present law tax at these levels is due to the sharper reductions in the first bracket rate, the split first bracket, and the effect of the minimum standard deduction. Due to the structural reforms, particularly the repeal of the dividends received credit the amount of tax reduction for persons with incomes of $50,000 or more will average approximately 13.5 percent of their present tax (excluding the alternative capital gains tax). Since the present tax for these individuals is already considerably higher relative to income than it is for those with incomes below $3,000, this 13.5-percent reduction in tax necessarily represents a greater increase in aftertax income.

In addition to a rate reduction the present bill contains a number of provisions designed to increase the equity of the tax system, some of which increase and some of which decrease the total revenue. These provisions are listed in part I above.

The bill also significantly improves the pattern of progression in the tax structure. At the lower end of the income tax scale, the minimum standard deduction will effectively eliminiate tax for all single people with adjusted gross incomes below $900 and for married couples with incomes below $1,600 (with higher minimum levels of $700 for each dependent). Furthermore the division of the present first surtax bracket (which is $4,000 wide for a married couple) into four narrower brackets permits greater proportionate tax reduction for families and single individuals whose total income leaves them close to a poverty level.

At the upper end of the income scale, under the demands of war finance, progression has been carried to the extreme of rates that under peacetime conditions are clearly excessive and inhibit individual initiative. Over the years the Congress has been faced with the necessity of making statutory exceptions, through special deductions, lower capital gains rates and the like, until there now is a wide range of effective rates applicable to people with the same economic income. Your committee's bill deals with this problem by applying the reductions made in these higher brackets to those cases where current rates are excessive and also by removing special benefits in the law which account for part of this divergence in rates.

(d) Principal changes from the House bill

Your committee's amendments make a number of changes in the House bill. These are:

(1) The 14-percent withholding rate, scheduled under the House bill to become effective in 1965, is made effective in 1964, 8 days after the enactment of this legislation. This change is needed because lower tax rates will apply to all of 1964 incomes but withholding will continue at 18 percent (rather than the 15 percent provided in the House bill) until this bill goes into effect.

(2) The restoration of the deduction for State and local taxes on gasoline and for other State and local registration taxes on automobiles. Under the House bill individuals who itemize their personal deductions were not to be allowed deductions for these items.

(3) The deletion of the House provision reducing the tax rate on capital gains where the assets have been held more than 2 years. Under the House bill certain capital gains held more than 2 years were to achieve an effective lower rate of tax by the reduction of the percentage of such gains included in income from 50 to 40 percent and by the reduction of the alternative tax rate on these gains from 25 to 21 percent. Your committee believes that further reduction in capital gains should be deferred until Congress has a further opportunity to examine these rates and related problems. Even though the capital gains provisions are not reduced in this bill, those who include half of their capital gains in their regular income tax base (96 percent) will obtain under this bill the same percentage tax reduction on these capital gains as is applicable to other kinds of income.

(4) The taxation of group term insurance paid for through the employer is to apply to the cost of insurance for over $70,000 of coverage rather than $30,000 as provided by the House bill.

(5) A new deduction for political contributions of up to $50 a year for a single person and up to $100 a year for a married couple is provided.

(6) The child-care deduction is liberalized, particularly with respect to working wives. Under present law this deduction is reduced in the case of a working wife by the excess of the family income over $4,500. The bill raises this limitation to $7,000.

(7) A new provision is added limiting the use of excess foreign tax credits arising from mineral extraction. Where the foreign tax on the extraction activity exceeds the U.S. tax, because of the allowance of percentage depletion under the U.S. tax, the resulting excess foreign tax credit may not be used against U.S. tax on income arising from nonmineral activities.

(8) The limitation on the business travel expense deduction enacted in the Revenue Act of 1962 is repealed. Thus there will no longer be an allocation of the travel expense where the taxpayer combines a business trip with a vacation.

(9) A new provision provides that where an employee moves and the employer reimburses him for selling costs on his house and losses incurred on the sale of the house attributable to the fact that it must be sold more quickly than usual, the reimbursement is to be treated as a part of the selling price of the house (rather than as compensation).

(10) Groups of affiliated corporations eligible to file a consolidated return and those eligible which do not do so, will be permitted to take a 100 percent dividends received deduction with respect to dividends received from other members of the controlled group, provided the group elects to take only one surtax exemption and meets certain other conditions.

(11) A new provision is added extending the installment method of accounting to business firms maintaining so-called revolving credit accounts.

(12) A new provision is added to allow taxpayers who suffered losses through foreign expropriation after 1958 to carry these losses forward for 10 years (instead of the usual 3-year carryback and 5-year carryforward).

(13) A new provision liberalizes the retirement income credit. This increases the amounts of retirement income on which the credit is computed to make the credit more nearly analogous to the social security exclusion.

(14) A 5-year carryover of unused charitable contributions is provided for individuals, deductions for gifts of future interests are restricted, and contributions to private foundations are made ineligible for the unlimited charitable contributions deduction.

(15) A new amendment provides that companies issuing face amount certificates may invest up to 25 percent of their total assets in tax-exempt obligations without losing a deduction for interest paid to the shareholders.

(16) A new amendment provides a tax-free status for a stock-for-stock reorganization where the corporation acquiring the stock exchanges the stock of its parent for the stock of the acquired corporation.

(17) A new provision provides for the retroactive qualification of union negotiated multiemployer pension plans where these pension plans are subsequently qualified.

(18) A new provision makes possible the coverage under qualified pension plans of U.S. employees of foreign subsidiaries or of U.S. employees of foreign branches of domestic corporations.

(19) In the case of employee stock options, the House provision is liberalized with respect to the restrictions imposed where one option is outstanding and a subsequent option is acquired and the effective date is changed to apply to options granted after December 31, 1963 (instead of June 11, 1963).

(20) A new provision provides that in the case of contested liabilities, the deduction is to be taken in the year of the payment where this occurs before the contest is settled.

(21) The personal holding company provision of the House bill is liberalized somewhat in the case of the test as to when rent is considered personal holding company income and also with respect to the exemptions for consumer finance companies.

(22) Three new provisions are added with respect to insurance companies, providing additional time for special treatment mutalization distributions, providing capital gains treatment with respect to the accrual of bond discount in certain cases, and correcting a technical error in present law.

(23) Liberalizing amendments are provided giving regulated investment companies more time for the mailing of notices to shareholders and with respect to the treatment of redemptions by unit investment trusts.

(24) An amendment liberalizes somewhat the treatment accorded "small business corporations"; namely, those treated essentially like partnerships for tax purposes.

(25) An amendment provides that a purchaser, mortgagee, or pledgee of a motor vehicle will not be subject to a Federal tax lien against the motor vehicle unless the purchaser, mortgagee, or pledgee has actual notice of the existence of the lien.

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III. REVENUE ESTIMATES

The revenue effect of your committee's bill is shown in tables 1 through 4 below. (Pt. A of tables 1 through 3 refers to estimates under your committee's bill and pt. B in each case to estimates under the House bill.) Estimates in the tables are based on income levels assumed for the calendar year 1963 but do not take into account any "feedback" to the economy anticipated from this bill. Table 1 shows the estimated impact of the various provisions contained in your committee's bill and the House bill upon calendar year 1964 and 1965 tax liabilities and also upon liabilities in the long run. Table 2 shows the estimated effect of your committee's bill and the House bill upon receipts in the fiscal years 1964 and 1965.

Table 1 indicates that your committee's bill can be expected to decrease calendar year 1964 tax liabilities by $7.9 billion and calendar year 1965 liabilities by $11.6 billion (the latter figure includes the $7.9 billion reduction). The calendar year 1965 effect is virtually identical with the long-term effect of the bill before taking into account any impact of the reductions upon the economy. Of the $11.6 billion reduction in 1965, $9.2 billion will go to individuals, or nearly 80 percent of the total. Revenue raising structural changes for the calendar year 1965 amount to $740 million but are partially offset by other liberalizing provisions reducing the net increase to $160 million.

Table 2 shows that your committee's bill will decrease revenues in the fiscal year 1964 by $1.9 billion and in the fiscal year 1965 by $8.4 billion (the latter figure includes the $1.9 billion reduction). These figures are considerably lower than the calendar year liability figures for the same year; first, because of the fact that the fiscal year ends in the middle of the calendar year; and, second, because the calendar year data are shown on the basis of liability rather than receipts. Liabilities indicate the amount of tax liability attributable to income of the year in which it is earned; receipts show the actual amount collected in the year in question. Since collection tends to lag behind the accruing of the liability, tax reductions show up in later years when shown on a "receipt" basis than when shown on a "liability" basis.

It is important to note that it is not expected that actual tax revenues in the fiscal year 1964 and future years will be reduced by the full $1.9 or $8.4 billion referred to above. It is anticipated that income levels in these years will be substantially higher as a result of the economic stimulus of the tax cut and will generate revenues significantly offsetting the budgetary impact of these rate reductions.

The stimulative effects of the tax reduction are expected to produce, according to the Treasury Department, relatively modest amounts of increased income in the first months, with the result that the "feedback" effect on the fiscal year 1964 revenues is expected to amount to only $200 million. As a result, the gross tax loss of $1.9 billion for the fiscal year 1964 is expected to be reduced to $1.5 billion after the "feedback" effect. The Treasury Department has estimated that the increased revenues from the rise of income, however, will amount to about $4 billion in the fiscal year 1965. Thus, the Treasury estimates that while tax reductions during that year would lose an estimated $8.4 billion of revenue at 1963 income levels, the net cost after allowing for the revenues generated by the expansion in income and

profits induced by the tax program would be limited to approximately $4.3 billion. The expansionary effect of the tax reductions on future years' revenues can be expected to be considerably larger than for the first 2 years. The order of magnitude was indicated in the discussion in part II.

Part A of table 3 shows by adjusted gross income class the distribution of changes in estimated tax liabilities for individuals when your committee's bill is fully effective. This table shows this distribution for each of the major rate and structural changes. These data are shown both in terms of amount of tax liability involved and the percentage change each of these is of present tax liability. It indicates that the rate changes alone would decrease tax liability by 20 percent while the structural changes would increase tax liability by 0.3 percent, resulting in the net reduction of 19.7 percent. Part B of table 3 presents similar data under the House bill.

Table 4 compares the tax liability effect of your committee's amendments with the House bill. This table indicates that in the calendar year 1964 your committee's amendments would decrease tax liabilities $680 million more than the House bill, in 1965 your committee's amendments are expected to decrease tax liabilities $395 million more and in the long run $185 million more.

The impact of the capital gains provisions is excluded from table 3 because of the difficulty of showing these changes by adjusted gross income class. Part A of table 1 sets forth the overall effect of the changes in the taxation of capital gains under your committee's bill: an increase of $115 million in calendar year 1964 tax liabilities, $120 million in 1965, and $50 million in the long run.[1]

As set forth in part A of table 2, the estimated overall revenue loss, before taking into account acceleration of corporation tax payments, is $2.2 billion in fiscal year 1964. This is $400 million less than was estimated in the budget. According to the Treasury Department this difference is due to the assumption of an earlier effective date in the budget document for institution of the 14-percent withholding. Similarly, according to the Treasury Department, the $9.3 billion revenue loss ($8.4 billion plus $900 million of accelerated corporation tax payments) estimated in part A of table 2 for fiscal year 1965 is greater than the loss shown in the budget by approximately $1.1 billion. The difference is ascribed primarily to $400 million due to the change in date of the reduced withholding and to the $680 million due to changes in structural provisions as shown in table 4.

[1] When this $115 million estimate for 1964 under your committee's bill is compared with the $295 million estimate under the House bill (pt. B of table 1) as subsequently revised to $215 million, the effect of your committee's action as compared to action by the House is a decrease in tax liability of $100 million in calendar year 1964 (see line 7 of table 4). Similarly, when the $120 million estimated increase in calendar year 1965 tax liabilities under your committee's bill is compared with the $170 million estimate under the House bill (pt. B of table 1), as subsequently revised to $80 million, the effect of your committee's action as compared to action by the House is an increase in tax liability of $40 million (see line 7 of table 4).

TABLE 1.—*Revenue bill of 1964, H.R. 8363—Estimated decrease in tax liability* [1] *(−) and increase (+) (before feedback) of provisions of bill*

[In millions of dollars]

A. AS APPROVED BY SENATE COMMITTEE ON FINANCE

	Calendar year 1964 liability			Calendar year 1965 liability			Long run liability		
	Individual	Corporate	Total	Individual	Corporate	Total	Individual	Corporate	Total
A. Tax program:									
Rate changes: Basic rates	−6,310	−1,320	−7,630	−9,470	−2,190	−11,660	−9,470	−2,190	−11,660
Structural changes:									
(a) Revenue raising:									
1. Group term insurance	(2)		(2)	(2)		(2)	(2)		(2)
2. Bank loan insurance	+5		+5	+5		+5	+10		+10
3. Sick pay inclusion	+110		+110	+110		+110	+110		+110
4. Deduction of personal taxes	+190		+190	+190		+190	+190		+190
5. Casualty loss deduction	+50		+50	+50		+50	+50		+50
6. Aggregation of mineral properties		+40	+40		+40	+40		+40	+40
7. Personal holding companies	+15		+15	+15		+15	+15		+15
8. Repeal of dividend credit and increase in exclusion	+120		+120	+300		+300	+300		+300
9. Multiple corporation provisions		+30	+30		+30	+30		+30	+30
Total, revenue raising	+490	+70	+560	+670	+70	+740	+675	+70	+745
(b) Revenue reducing:									
10. Medical expense deduction	−10		−10	−10		−10	−10		−10
11. Child care allowance	−20		−20	−20		−20	−20		−20
12. Moving expenses	−105		−105	−105		−105	−105		−105
13. Income averaging	−40		−40	−40		−40	−40		−40
14. Minimum standard deduction	−320		−320	−320		−320	−320		−320
15. Repeal 2-percent tax on consolidated returns		−50	−50		−50	−50		−50	−50
16. Political contributions	−25		−25	−5		−5	−15		−15
17. Travel expenses	−5		−5	−5		−5	−5		−5
18. Installment sales treatment		[3] −140	−140		−10	−10		−10	−10
19. Expropriation loss carryover		(2)	(2)		−5	−5		−5	−5
20. Retirement income credit	−10		−10	−10		−10	−10		−10
Total, revenue reducing	−535	−190	−725	−515	−65	−580	−525	−65	−590
Total, structural changes	−45	−120	−165	+155	+5	+160	+150	+5	+155
Total, rate and structural changes, tax program	−6,355	−1,440	−7,795	−9,315	−2,185	−11,500	−9,320	−2,185	−11,505

Capital gains revisions (including induced effects):									
1. Unlocking of capital gains from general rate reduction	+130		+130	+130		+130	+50		+50
2. Sale or exchange of real estate		(3)	(3)		+5	+5		+15	+15
3. Sales of residences by taxpayers aged 65 or over	−10		−10	−10		−10	−10		−10
4. Capital gains treatment of iron ore royalties		−5	−5		−5	−5		−5	−5
Total, capital gains revisions	+120	−5	+115	+120	0	+120	+40	+10	+50
Total, tax program	−6,235	−1,445	−7,680	−9,195	−2,185	−11,380	−9,280	−2,175	−11,455
B. Revision of 1962 legislation:									
1. Repeal of requirement to reduce basis by investment credit	−20	−140	[4] −160	−25	−170	[4] −195	−25	−170	−195
2. Allow investment credit for elevators and escalators		−10	−10		−10	−10		−10	−10
Total, revision of 1962 legislation	−20	−150	−170	−25	−180	−205	−25	−180	−205
C. Total, revenue bill of 1964	−6,255	−1,595	−7,850	−9,220	−2,365	−11,585	−9,305	−2,355	−11,660

See footnotes at end of table, p. 17.

TABLE 1.—*Revenue bill of 1964, H.R. 8363—Estimated decrease in tax liability* [1] (—) *and increase* (+) (*before feedback*) *of provisions of bill*—Continued

[In millions of dollars]

B. AS PASSED BY HOUSE OF REPRESENTATIVES

	Calendar year 1964 liability			Calendar year 1965 liability		
	Individual	Corporate	Total	Individual	Corporate	Total
A. 1963 tax program:						
Rate changes	−6,310	−1,320	−7,630	−9,470	−2,190	−11,660
Structural changes:						
(a) Revenue raising:						
1. Group term insurance	+5		+5	+5		+5
2. Bank loan insurance	+5		+5	+5		+5
3. Sick pay exclusion	+110		+110	+110		+110
4. Deduction of personal taxes	+520		+520	+520		+520
5. Casualty loss deduction	+50		+50	+50		+50
6. Aggregation of mineral properties		+40	+40		+40	+40
7. Personal holding companies	+15		+15	+15		+15
8. Repeal of dividend credit and increase in exclusion	+120		+120	+300		+300
9. Multiple corporation provisions		+35	+35		+35	+35
Total, revenue raising	+825	+75	+900	+1,005	+75	+1,080
(b) Revenue reducing:						
10. Medical expense deduction	−10		−10	−10		−10
11. Child care allowance	−5		−5	−5		−5
12. Moving expenses	−60		−60	−60		−60
13. Income averaging	−40		−40	−40		−40
14. Minimum standard deduction	−320		−320	−320		−320
15. Repeal 2-percent tax on consolidated returns		−50	−50		−50	−50
Total, revenue reducing	−435	−50	−485	−435	−50	−485
Total, structural changes	+390	+25	+415	+570	+25	+595
Total, rate and structural changes, 1963 tax program	−5,920	−1,295	−7,215	−8,900	−2,165	−11,065

Capital gains revision (including induced effects):						
1. 50- to 40-percent inclusion [5]	+340		+340	+210		+210
2. Sale or exchange of real estate		(2)	(2)		+5	+5
3. Carryover of losses	−30		−30	−30		−30
4. Sales of residences by taxpayers aged 65 or over	−10		−10	−10		−10
5. Capital gains treatment of iron ore royalties		−5	−5		−5	−5
Total, capital gains revision	+300	−5	+295	+170	0	+170
Total, 1963 tax program	−5,620	−1,300	−6,920	−8,730	−2,165	−10,895
B. Revision of 1962 legislation:						
1. Repeal requirement to reduce basis by investment credit	−20	−125	[4] −145	−25	−160	[4] −185
2. Allow investment credit for elevators and escalators		−10	−10		−10	−10
Total, revision of 1962 legislation	−20	−135	−155	−25	−170	−195
C. Total	−5,640	−1,435	−7,075	−8,755	−2,335	−11,090

[1] At levels of income estimated for the calendar year 1963.
[2] Less than $2,500,000.
[3] Includes relatively small loss attributable to individuals.
[4] Treasury Department estimate; estimate of Staff of Joint Committee on Internal Revenue Taxation is $245,000,000 for 1964, and $305,000,000 for 1965.
[5] Includes amounts shown in part A as "unlocking due to general rate reduction."

TABLE 2.—*Revenue bill of 1964, H.R. 8363—Estimated decrease in fiscal year receipts* [1] *(−) and increase (+) (before feedback) of provisions of bill*

[In millions of dollars]

A. AS APPROVED BY SENATE COMMITTEE ON FINANCE

	Fiscal year 1964 receipts			Fiscal year 1965 receipts		
	Individual	Corporation	Total	Individual	Corporation	Total
A. Tax program:						
Rate changes:						
Basic rates	[2] −2,200		−2,200	[2] −7,760	−1,320	−9,080
Acceleration of corporate payments		+260	+260		+900	+900
Total	−2,200	+260	−1,940	−7,760	−420	−8,180
Structural changes:						
(a) Revenue raising:						
1. Group term insurance				(3)		(3)
2. Bank loan insurance				+5		+5
3. Sick pay exclusion				+110		+110
4. Deduction of personal taxes				+190		+190
5. Casualty loss deduction				+50		+50
6. Aggregation of mineral properties					+40	+40
7. Personal holding companies				+15		+15
8. Repeal of dividend credit and increase in exclusion				+120		+120
9. Multiple corporation provisions					+30	+30
Total, revenue raising				+490	+70	+560
(b) Revenue reducing:						
10. Medical expense deduction				−10		−10
11. Child care allowance				−20		−20
12. Moving expenses				−105		−105
13. Income averaging				−40		−40
14. Minimum standard deduction				−320		−320
15. Repeal 2-percent tax on consolidated returns					−50	−50
16. Political contributions				−25		−25
17. Travel expenses				−5		−5
18. Installment sales treatment					[4] −140	−140
19. Expropriation loss carryover					(3)	(3)

20. Retirement income credit				−10		−10
Total, revenue reducing				−535	−190	−725
Total, structural changes				−45	−120	−165
Total, rate and structural changes, tax program	−2,200	+260	−1,940	−7,805	−540	−8,345
A. Capital gains revisions (including induced effects):						
1. Unlocking of capital gains from general rate reduction				+130		+130
2. Sale or exchange of real estate					([3])	([3])
3. Sales of residences by taxpayers aged 65 or over				−10		−10
4. Capital gains treatment of iron ore royalties					−5	−5
Total, capital gains revisions				+120	−5	+115
Total, tax program	−2,200	+260	−1,940	−7,685	−545	−8,230
B. Revision of 1962 legislation:						
1. Repeal of requirement to reduce basis by investment credit				−20	−140	[4]−160
2. Allow investment credit for elevators and escalators					−10	−10
Total, revision of 1962 legislation				−20	−150	−170
C. Total, revenue bill of 1964	−2,200	+260	−1,940	−7,705	−695	−8,400

See footnotes at end of table, p. 21.

TABLE 2.—*Revenue bill of 1964, H.R. 8363—Estimated decrease in fiscal year receipts* [1] (−) *and increase* (+) *(before feedback) of provisions of bill*—Continued

[In millions of dollars]

B. AS PASSED BY HOUSE OF REPRESENTATIVES

	Fiscal year 1964 receipts			Fiscal year 1965 receipts		
	Individual	Corporation	Total	Individual	Corporation	Total
A. 1963 tax program:						
Rate changes	−2,430		−2,430	−7,530	−1,320	−8,850
Acceleration of payments		+260	+260		+900	+900
Total	−2,430	+260	−2,170	−7,530	−420	−7,950
Structural changes:						
(a) Revenue raising:						
1. Group term insurance				+5		+5
2. Bank loan insurance				+5		+5
3. Sick pay exclusion				+110		+110
4. Deduction of personal taxes				+520		+520
5. Casualty loss deduction				+50		+50
6. Aggregation of mineral properties					+40	+40
7. Personal holding companies				+15		+15
8. Repeal of dividend credit and increase in exclusion				+120		+120
9. Multiple corporation provisions					+35	+35
Total, revenue raising				+825	+75	+900
(b) Revenue reducing:						
10. Medical expense deduction				−10		−10
11. Child care allowance				−5		−5
12. Moving expenses				−60		−60
13. Income averaging				−40		−40
14. Minimum standard deduction				−320		−320
15. Repeal 2-percent tax on consolidated returns					−50	−50
Total, revenue reducing				−435	−50	−485
Total structural changes				+390	+25	+415
Total rate and structural changes, 1963 tax program	−2,430	+260	−2,170	−7,140	−395	−7,535

Capital gains revision (including induced effects):						
1. 50 to 40 percent inclusion				+340		+340
2. Sale or exchange of real estate					(3)	(3)
3. Carryover of losses				−30		−30
4. Sales of residences by taxpayers aged 65 or over				−10		−10
5. Capital gains treatment of iron ore royalties					−5	−5
Total, capital gains revision				+300	−5	+295
Total, 1963 tax program	−2,430	+260	−2,170	−6,840	−400	−7,240
B. Revision of 1962 legislation:						
1. Repeal requirement to reduce basis by investment credit		−15	−15	−20	−125	[5]−145
2. Allowing investment credit for elevators and escalators		−5	−5		−10	−10
Total, revision of 1962 legislation		−20	−20	−20	−135	−155
C. Total	−2,430	+240	−2,190	−6,860	−535	−7,395

[1] At levels of income estimated for the calendar year 1963.
[2] Assumes effective date for withholding change of Feb. 22, 1964.
[3] Less than $2,500,000.
[4] Includes relatively small loss attributable to individuals.
[5] Treasury Department estimate; estimate of Staff of Joint Committee on Internal Revenue Taxation is $245,000,000.

TABLE 3.—*Revenue bill of 1964, H.R. 8363—Change in tax liability*[1] *resulting from rate and structural changes for individuals when fully effective*

A. AS APPROVED BY SENATE COMMITTEE ON FINANCE

Adjusted gross income class (thousands of dollars)	Rate change	Structural changes															Total rate and structural changes
		Group term and other insurance	Sick pay exclusion	Limitation of deductions	Casualty loss deduction	Personal holding companies	Dividend credit and exclusion	Medical care deduction (aged)	Child care allowance	Moving expenses	Income averaging	Minimum standard deduction	Political contribution	Travel and entertainment	Retirement income credit expense	Total structural changes	
	[In millions of dollars]																
0 to 3	−400	(2)	5	5	(2)	(2)	(2)	(2)	(2)	(2)	----------	−170	(2)	(2)	(2)	−160	−560
3 to 5	−1,020	(2)	20	20	5	(2)	10	(2)	−10	−25	----------	−100	(2)	(2)	(2)	−80	−1,100
5 to 10	−3,905	(2)	55	80	25	(2)	30	(2)	−10	−40	(2)	−50	(2)	(2)	−5	+85	−3,820
10 to 20	−2,285	(2)	25	45	15	(2)	50	(2)	(2)	−25	−10	----------	(2)	−5	−5	+90	−2,195
20 to 50	−1,150	(2)	5	20	5	(2)	85	−5	(2)	−10	−20	----------	−10	(2)	(2)	+70	−1,080
50 and over	−710	10	(2)	20	(2)	15	125	−5	(2)	−5	−10	----------	−5	(2)	(2)	+145	−565
Total	−9,470	10	110	190	50	15	300	−10	−20	−105	−40	−320	−15	−5	−10	+150	−9,320
	Change as a percent of present tax																
0 to 3	−27.6	(2)	0.3	0.3	(2)	(2)	(2)	(2)	(2)	(2)	----------	−11.7	(2)	(2)	(2)	−11.0	−38.6
3 to 5	−25.3	(2)	.5	.5	0.1	(2)	0.2	(2)	−0.2	−0.6	----------	−2.5	(2)	(2)	(2)	−2.0	−27.3
5 to 10	−21.3	(2)	.3	.4	.1	(2)	.2	(2)	−.1	−.2	(2)	−.3	(2)	(2)	(2)	+.5	−20.9
10 to 20	−18.0	(2)	.2	.4	.1	(2)	.4	(2)	(2)	−.2	−0.1	----------	(2)	(2)	(2)	+.7	−17.3
20 to 50	−17.0	(2)	.1	.3	.1	(2)	1.3	−0.1	(2)	−.1	−.3	----------	−0.1	(2)	(2)	+1.0	−16.0
50 and over	−17.0	0.2	(2)	.5	(2)	0.4	3.0	−.1	(2)	−.1	−.2	----------	−.1	(2)	(2)	+3.5	−13.5
Total	−20.0	(2)	.2	.4	.1	(2)	.6	(2)	(2)	−.2	−.1	.7	(2)	(2)	(2)	+.3	−19.7

B. AS PASSED BY THE HOUSE OF REPRESENTATIVES

Adjusted gross income class (thousands of dollars)	Rate change	Structural changes												Total
		Group term and other insurance	Sick pay exclusion	Limitation of deductions	Casualty loss deduction	Personal holding companies	Dividend credit and exclusion	Medical care deduction (aged)	Child care allowance	Moving expenses	Income averaging	Minimum standard deduction	Total	
	[In millions of dollars]													
0 to 3	−400	(2)	5	10	(2)	(2)	(2)	(2)	(2)	(2)	----------	−170	−155	−555
3 to 5	−1,020	(2)	20	50	5	(2)	10	(2)	−5	−15	----------	−100	−35	−1,055
5 to 10	−3,905	(2)	55	220	25	(2)	30	(2)	(2)	−25	(2)	−50	+255	−3,650
10 to 20	−2,285	(2)	25	130	15	(2)	50	(2)	(2)	−15	−10	----------	+195	−2,090
20 to 50	−1,150	5	5	60	5	(2)	85	−5	(2)	−5	−20	----------	+130	−1,020
50 and over	−710	10	(2)	50	(2)	15	125	−5	(2)	(2)	−10	----------	+185	−525
Total	−9,470	15	110	520	50	15	300	−10	−5	−60	−40	−320	+575	−8,895
	Change as a percent of present tax													
0 to 3	−27.6	(2)	0.3	0.7	(2)	(2)	(2)	(2)	(2)	(2)	----------	−11.7	−10.7	−38.3
3 to 5	−25.3	(2)	.5	1.2	0.1	(2)	0.2	(2)	−0.1	−0.4	----------	−2.5	−.9	−26.2
5 to 10	−21.3	(2)	.3	1.2	.1	(2)	.2	(2)	(2)	−.1	(2)	−.3	+1.4	−19.9
10 to 20	−18.0	(2)	.2	1.0	.1	(2)	.4	(2)	(2)	−.1	−0.1	----------	+1.5	−16.4
20 to 50	−17.0	0.1	.1	.9	.1	(2)	1.3	−0.1	(2)	−.1	−.3	----------	+1.9	−15.1
50 and over	−17.0	.2	(2)	1.2	(2)	0.4	3.0	−.1	(2)	(2)	−.2	----------	+4.4	−12.6
Total	−20.0	(2)	.2	1.1	.1	(2)	.6	(2)	(2)	−.1	−.1	−.7	+1.2	−18.8

[1] Excludes effect of capital gains provisions and repeal of the requirement to reduce basis by amount of investment credit.

[2] Less than $2,500,000 or 0.05 percent.

TABLE 4.—*Action by Senate Finance Committee on H.R. 8363 resulting in significant change in tax liability over House bill, calendar years 1964 and 1965 and long run*

[Millions]

	Change in tax liability from House bill		
	1964	1965	Long run
1. Deduction for political contributions	−$25	−$5	[1] −$15
2. Liberalized deduction for child care expense	−15	−15	−15
3. Elimination of allocation of travel expenses	−5	−5	−5
4. 100 percent intercorporate dividend deduction for certain affiliated groups	−5	−5	−5
5. Restoration of deduction of State and local gas tax and auto registration fees	−330	−330	−330
6. Allowance to reimbursed employee, as part of sales price, of selling costs and loss on forced sale of house	−45	−45	−45
7. Elimination of general capital gains provision	−100	+40	+260
8. Allowance of installment sales treatment for revolving credit plans	−140	−10	−10
9. Permitting election of 10-year carryforward without carryback for expropriation losses	([2])	−5	[2] −5
10. Increasing from $50,000 to $70,000 the minimum group-term life insurance subject to tax	−5	−5	−5
11. Liberalize retirement income credit on certain joint returns	−10	−10	−10
Total	−680	−395	−185

[1] $25,000,000 for presidential election year; 50 percent of that amount for congressional election year and 25 percent for off year; average about $15,000,000 per year.

[2] Less than $2,500,000 in 1964 and practically exhausted by 1970.

IV. GENERAL EXPLANATION

A. RATE CHANGES

1. *Individual income tax rates (sec. 111 of the bill and sec. 1 of the code)*

The most important change made by this bill is the individual income tax rate reduction. The bill, in both the House and your committee's versions, provides an individual income tax rate reduction of $9.47 billion spread over the 2 calendar years, 1964 and 1965. Over this 2-year period, the present rates, which range from 20 percent on the first $2,000 or $4,000 (the former for single persons and the latter for married couples) and 91 percent on incomes over $200,000 or $400,000 are reduced to a range of from 14 percent on the first $500 or $1,000 to 70 percent on incomes over $100,000 or $200,000. This represents an average rate reduction of 20 percent. Approximately two-thirds of this reduction is made effective in 1964 and the remaining one-third in 1965.

Table 5 shows the individual income tax rates under present law and under the House and committee bill, both for 1964 and for subsequent years. A separate table with rates, as nearly as possible halfway between those applicable for single persons and for married couples is provided for heads of households. The withholding tax rate of 18 percent under present law is reduced to 14 percent not only for 1965 and subsequent years but, under your committee's action also for 1964, starting 1 week after the date of enactment. The House bill would have provided a 15-percent rate for 1964. Wage bracket withholding tables provided by the bill reflect similar reductions in withholding tax rates. The 14-percent withholding tax rate is designed to withhold the appropriate amount of tax at an income level of $2,000 for a single person, or $4,000 in the case of a married couple, using the standard deduction.

TABLE 5.—*Individual income tax rates under present law and schedules provided by House and committee bill for 1964 and 1965*

Taxable income brackets (in thousands of dollars)		Present rates	Rates provided under House and committee bill—	
Single person	Married (joint)		1964 [1]	1965
		Percent	*Percent*	*Percent*
0 to 0.5	0 to 1	20	16.0	14
0.5 to 1	1 to 2	20	16.5	15
1 to 1.5	2 to 3	20	17.5	16
1.5 to 2	3 to 4	20	18.0	17
2 to 4	4 to 8	22	20.0	19
4 to 6	8 to 12	26	23.5	22
6 to 8	12 to 16	30	27.0	25
8 to 10	16 to 20	34	30.5	28
10 to 12	20 to 24	38	34.0	32
12 to 14	24 to 28	43	37.5	36
14 to 16	28 to 32	47	41.0	39
16 to 18	32 to 36	50	44.5	42
18 to 20	36 to 40	53	47.5	45
20 to 22	40 to 44	56	50.5	48
22 to 26	44 to 52	59	53.5	50
26 to 32	52 to 64	62	56.0	53
32 to 38	64 to 76	65	58.8	55
38 to 44	76 to 88	69	61.0	58
44 to 50	88 to 100	72	63.5	60
50 to 60	100 to 120	75	66.0	62
60 to 70	120 to 140	78	68.5	64
70 to 80	140 to 160	81	71.0	66
80 to 90	160 to 180	84	73.5	68
90 to 100	180 to 200	87	75.0	69
100 to 150	200 to 300	89	76.5	70
150 to 200	300 to 400	90	76.5	70
200 and over	400 and over	91	77.0	70

[1] Provides ¾ of tax cut in 1964.

The rate brackets provided by the House and committee bill differ from those under present law in that what is now the first bracket is divided into four brackets:

Single persons	*Married couples*
\$0 to \$500	\$0 to \$1,000
\$500 to \$1,000	\$1,000 to \$2,000
\$1,000 to \$1,500	\$2,000 to \$3,000
\$1,500 to \$2,000	\$3,000 to \$4,000

Splitting this first bracket into four brackets has several advantages. First, it makes it possible to have a lower starting rate than would otherwise be possible, given the same revenue loss. Only splitting this first bracket into four parts makes it possible to provide a 30-percent tax reduction for those with the lowest taxable income, who need the tax cut the most. Second, it makes it possible to provide some progression in the portion of the rate structure where none has been provided before. The significance of this is that over half of the taxpayers presently are subject only to the first bracket rate. As among taxpayers in this major group, the present rate structure provides no differentiation in applicable tax rates.

Table 6 shows the percentage of tax rate reduction provided in each rate bracket for 1965 and subsequent years. This table indicates that the new 14-percent rate represents a 30-percent reduction; the 15-percent rate, a 25-percent cut; and the 16-percent rate, a 20-percent cut. The average reduction in these first four brackets is 22.5 percent. Above this level the percentage reductions, up to a taxable income level of about \$50,000 for single persons or \$100,000 for married couples, is as nearly a uniform 15-percent rate reduction as practicable for a smooth progression. Above this \$50,000 or \$100,000 taxable income

level, the rate reductions again gradually increase until the top rate is reached at $200,000 or $400,000 where a 23-percent rate reduction is provided. This rate schedule, therefore, provides a minimum reduction of approximately 15 percent for all tax brackets. In addition, it provides extra reductions in the very lowest tax brackets where the impact of the present taxes is the most heavy. It also provides larger reductions in the very highest bracket where it is quite clear the present rates are too steeply graduated. These rates, which were developed during World War II to assure equality of sacrifice, are no longer appropriate under today's conditions.

TABLE 6.—*Individual income tax rates under present law and under House and committee bill for 1965*

Taxable income bracket (thousands of dollars)		Present law rate	House and committee bill	
Single person	Married (joint)		Rate for 1965 and subsequent years	Percentage reduction from present law rates
		Percent	*Percent*	*Percent*
0 to 0.5	0 to 1	20	14	30 } 22.5
0.5 to 1	1 to 2	20	15	25 }
1 to 1.5	2 to 3	20	16	20 }
1.5 to 2	3 to 4	20	17	15 }
2 to 4	4 to 8	22	19	14
4 to 6	8 to 12	26	22	15
6 to 8	12 to 16	30	25	17
8 to 10	16 to 20	34	28	18
10 to 12	20 to 24	38	32	16
12 to 14	24 to 28	43	36	16
14 to 16	28 to 32	47	39	17
16 to 18	32 to 36	50	42	16
18 to 20	36 to 40	53	45	15
20 to 22	40 to 44	56	48	14
22 to 26	44 to 52	59	50	15
26 to 32	52 to 64	62	53	15
32 to 38	64 to 76	65	55	15
38 to 44	76 to 88	69	58	16
44 to 50	88 to 100	72	60	17
50 to 60	100 to 120	75	62	17
60 to 70	120 to 140	78	64	18
70 to 80	140 to 160	81	66	19
80 to 90	160 to 180	84	68	19
90 to 100	180 to 200	87	69	21
100 to 150	200 to 300	89	70	21
150 to 200	300 to 400	90	70	22
200 and over	400 and over	91	70	23

The rate reductions found in table 6 reflect only the marginal rate reduction, or the rate reduction in each bracket. From the standpoint of the reduction in the total tax burden, however, it is important to realize that all taxpayers benefit from the rate reductions in all of the tax brackets below their top, or marginal, bracket. Thus, every taxpayer receives the benefit of the 30-percent reduction in the first bracket, either on his entire taxable income or on his first $500 or $1,000 of taxable income. Table 7 reflects this accumulative effect of the rate reduction provided by the House and committee bill. This is accomplished by showing for the top of each rate bracket—both for married couples and for single persons—the total tax under present law and under House and committee bill for 1965, together with the decrease, in terms of dollars and also percentages, which this represents in present tax liability. This indicates that on an accumulative basis the large rate reduction in the bottom bracket has an important effect on income up to $8,000 for married couples (or $4,000 for single per-

sons) and is of some significance for income levels up to about $40,000 for married couples (or $20,000 for single persons).

TABLE 7-A.—*Comparison of individual income tax liability under present law and under House and committee bill*

MARRIED COUPLE FILING JOINTLY

Amount of taxable income	Tax		Decrease in tax in House and committee bill	
	Present law	House and committee bill	Amount	Percent
$1,000	$200	$140	$60	30.0
$2,000	400	290	110	27.5
$3,000	600	450	150	25.0
$4,000	800	620	180	22.5
$8,000	1,680	1,380	300	17.9
$12,000	2,720	2,260	460	16.9
$16,000	3,920	3,260	660	16.8
$20,000	5,280	4,380	900	17.0
$24,000	6,800	5,660	1,140	16.8
$28,000	8,520	7,100	1,420	16.7
$32,000	10,400	8,660	1,740	16.7
$36,000	12,400	10,340	2,060	16.6
$40,000	14,520	12,140	2,380	16.4
$44,000	16,760	14,060	2,700	16.1
$52,000	21,480	18,060	3,420	15.9
$64,000	28,920	24,420	4,500	15.6
$76,000	36,720	31,020	5,700	15.5
$88,000	45,000	37,980	7,020	15.6
$100,000	53,640	45,180	8,460	15.8
$120,000	68,640	57,580	11,060	16.1
$140,000	84,240	70,380	13,860	16.5
$160,000	100,440	83,580	16,860	16.8
$180,000	117,240	97,180	20,060	17.1
$200,000	134,640	110,980	23,660	17.6
$300,000	223,640	180,980	42,660	19.1
$400,000	313,640	250,980	62,660	20.0

TABLE 7-B.—*Comparison of individual income tax liability under present law and under House and committee bill*

SINGLE PERSONS

Amount of taxable income	Tax		Decrease in tax in House and committee bill	
	Present law	House and committee bill	Amount	Percent
$500	$100	$70	$30	30.0
$1,000	200	145	55	27.5
$1,500	300	225	75	25.0
$2,000	400	310	90	22.5
$4,000	840	690	150	17.9
$6,000	1,360	1,130	230	16.9
$8,000	1,960	1,630	330	16.8
$10,000	2,640	2,190	450	17.0
$12,000	3,400	2,830	570	16.8
$14,000	4,260	3,550	710	16.7
$16,000	5,200	4,330	870	16.7
$18,000	6,200	5,170	1,030	16.6
$20,000	7,260	6,070	1,190	16.4
$22,000	8,380	7,030	1,350	16.1
$26,000	10,740	9,030	1,710	15.9
$32,000	14,460	12,210	2,250	15.6
$38,000	18,360	15,510	2,850	15.5
$44,000	22,500	18,990	3,510	15.6
$50,000	26,820	22,590	4,230	15.8
$60,000	34,320	28,790	5,530	16.1
$70,000	42,120	35,190	6,930	16.5
$80,000	50,220	41,790	8,430	16.8
$90,000	58,620	48,590	10,030	17.1
$100,000	67,320	55,490	11,830	17.6
$150,000	111,820	90,490	21,330	19.1
$200,000	156,820	125,490	31,330	20.0

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Table 8 shows the distribution by adjusted gross income classes (as distinguished from taxable income classes) of both the rate and structural changes provided by the bill when these changes are fully effective. This table also shows the number of taxable returns and tax liability under present law (not including the alternative tax on capital gains), together with the tax liability which will remain when the rate reductions and other changes provided by this bill are fully effective. The table further shows the percentage distribution of the rate, structural, and total changes made by this bill (expressed as a percentage of present tax liability by income class). This indicates that the rate changes on the average represent a 20-percent reduction. The percentage reductions vary within the various income classes from 17 percent for adjusted gross income above $10,000 up to 27.6 percent for incomes below $3,000. Taking the structural changes into account, the overall reduction averages 19.7 percent under your committee's bill and 18.8 percent under the House bill. The reductions under your committee's bill range from 13.5 percent for those with incomes over $50,000 to 38.6 percent for those with incomes under $3,000. Under the House bill this range was from 12.6 to 38.3 percent.

TABLE 8.—*Revenue bill of 1964—Distribution by adjusted gross income class of the full year effect of all tax changes*[1] *made by your committee's bill which directly affect individuals*

Adjusted gross income class (thousands of dollars)	Number of taxable returns (millions)	Tax liability under present law[2]	Effect of revenue bill of 1964			Total tax under revenue bill of 1964
			Rate change	Structural changes	Total	
		In millions of dollars				
0 to 3	9.7	1,450	−400	−160	−560	890
3 to 5	10.5	4,030	−1,020	−80	−1,100	2,930
5 to 10	22.9	18,300	−3,905	+85	−3,820	14,480
10 to 20	6.7	12,710	−2,285	+90	−2,195	10,515
20 to 50	1.0	6,760	−1,150	+70	−1,080	5,680
50 and over	.2	4,170	−710	+145	−565	3,605
Total	51.0	47,420	−9,470	+150	−9,320	38,100
		Percent distribution by income class				
0 to 3	19.0	3.1	4.2	−106.7	6.0	2.3
3 to 5	20.6	8.5	10.8	−53.3	11.8	7.7
5 to 10	44.9	38.6	41.2	+56.7	41.0	38.0
10 to 20	13.1	26.8	24.1	+60.0	23.6	27.6
20 to 50	2.0	14.3	12.1	+46.7	11.6	14.9
50 and over	.4	8.8	7.5	+96.7	6.1	9.5
Total	100.0	100.0	100.0	100.0	100.0	100.0
		Percent of tax liability under present law				
0 to 3		100.0	−27.6	−11.0	−38.6	61.4
3 to 5		100.0	−25.3	−2.0	−27.3	72.7
5 to 10		100.0	−21.3	+.5	−20.9	79.1
10 to 20		100.0	−18.0	+.7	−17.3	82.7
20 to 50		100.0	−17.0	+1.0	−16.0	84.0
50 and over		100.0	−17.0	+3.5	−13.5	86.5
Total		100.0	−20.0	+.3	−19.7	80.3

[1] Excluding effect of capital gains provisions and repeal of the requirement to reduce basis by amount of investment credit.
[2] Excludes alternative tax on capital gains.

The tax rate reductions described above take effect as of January 1, 1964, and January 1, 1965. For taxpayers with fiscal years falling partially in either the calendar year 1963 or the calendar year 1964, the bill provides for the proration of the rates applicable in the 2 years involved, according to the number of days in the fiscal year in question which falls in each calendar year.

The tax rate changes provided for individuals by this bill are expected to decrease tax liabilities in the calendar year 1964 by $6.3 billion and in the calendar year 1965 by $9.5 billion. The latter reduction is cumulative and includes the reduction of $6.3 billion for the calendar year 1964.

2. Minimum standard deduction (sec. 112 of the bill and sec. 141 of the code)

(*a*) *Present law.*—Under present law, single taxpayers who take the standard deduction, if they have no dependents, become taxable on income above $667. This represents a standard deduction of 10 percent ($67) plus the personal exemption ($600). For a married couple filing a joint return under present law, income becomes taxable above $1,333. This represents a 10-percent standard deduction ($133) plus two $600 exemptions. Similarly, a married couple with one child becomes taxable on income above $2,000 (a standard deduction of $200 plus three $600 exemptions).

(*b*) *General reasons for proposal.*—In addition to the rate reductions described above, the House and your committee concluded that it was desirable to remove from the tax rolls those persons with minimum incomes and also to provide those with incomes just slightly above these levels a somewhat larger tax reduction than is made available generally through the rate cuts.

The minimum standard deduction that the House and your committee have adopted, and which is described below, removes 1.5 million taxpayers, with very low incomes, from the tax rolls entirely.

The tax relief provided under this provision is almost entirely concentrated in the adjusted gross income classes of $5,000 or less, with much of it concentrated in income levels below $3,000. The total revenue loss anticipated from the minimum standard deduction of $320 million, for example, is distributed as follows:

Adjusted gross income class (thousands of dollars)	Change in tax liability from minimum standard deduction (millions of dollars)	Percentage change in present tax liability
0 to 3	−170	−11.7
3 to 5	−100	−2.5
5 to 10	−50	−.3
10 and over	0	0
Total	−320	−.7

The minimum standard deduction relieves persons at or near the subsistence level of much or all of their tax liability. In this respect the provision is much more economical than a personal exemption increase. The minimum standard deduction in the bill provides a floor of $300 above his exemption for a single person, a floor of $400

above exemptions for a married couple, and one of $600 above exemptions for a married couple with two children. Yet an increase in exemptions of only $100 would cost $2.6 billion, and one of $200 would cost $5 billion in lieu of the $320 million cost entailed in the minimum standard deduction.

(*c*) *General explanation of proposal.*—The bill provides that taxpayers who use the standard deduction may use either the regular 10-percent deduction or a minimum standard deduction, whichever is the larger. The minimum standard deduction in effect is $300 for the first exemption and $100 for each additional exemption. In the case of a married person filing a separate return, however, the minimum standard deduction is $200 for the first exemption and $100 for each additional exemption.[1] As under present law, the standard deduction, whether a "10-percent" deduction or a "minimum" deduction, may not exceed $1,000 (or $500 in the case of a married person filing a separate return).

Under the bill, a single person would be allowed a minimum standard deduction of $300 which, together with the personal exemption of $600, would mean that he would have no tax to pay until his income exceeded $900. Similarly, a married couple with no children would be allowed a minimum standard deduction of $400 ($300 for the first exemption, plus $100 for the second exemption). As a result, the married couple would pay tax on income only in excess of $1,600. A head of a household with one dependent also would be subject to tax only on income above $1,600, since the minimum standard deduction in this case also would be $300, plus $100 for the dependent. A married couple, both over age 65, would receive a minimum standard deduction of $600; i.e., $300 with respect to the first exemption, and $100 with respect to the three additional exemptions. This together with their four exemptions would mean they would pay no tax on the first $3,000 of income. This would also be true of blind persons with double exemptions.

The income levels under present law and under the bill at, or below, which there would be no tax, are as follows:

Status of taxpayer	Present law with 10-percent standard deduction	Minimum standard deduction provided by bill
Single person	[1] $667	$900
Married couple, no dependents or head of household, 1 dependent	[1] 1,333	1,600
Married couple, 1 dependent or head of household, 2 dependents	[1] 2,000	2,300
Married couple, 2 dependents or head of household, 3 dependents	[1] 2,667	3,000
Married couple, 3 dependents or head of household, 4 dependents	[1] 3,333	3,700
Married couple, 4 dependents or head of household, 5 dependents	[1] 4,000	4,400
Married couple, 5 dependents or head of household, 6 dependents	[1] 4,667	5,100
Married couple, 6 dependents or head of household, 7 dependents	5,333	5,800

[1] The amounts shown above assume that the income level under existing law is reached at exactly the level which would apply if a uniform 10 percent standard deduction were used. However, under present law for taxpayers with income below $5,000, a tax table with brackets is substituted for the uniform 10 percent. This modifies slightly all of the figures noted above. The income levels in these cases according to the tax table are $674, $1,324, $1,999, $2,674, $3,349, $3,999, and $4,649 respectively.

[1] In the case of married couples, where one takes the 10-percent standard deduction, rather than the minimum standard deduction, the other spouse must also take the 10-percent standard deduction. However, both may, if they so desire, elect to take the minimum standard deduction, which, as indicated above, is $200 for the 1st exemption and $100 for each additional exemption in the case of married persons filing separate returns.

Under the bill, taxpayers have the right to change their election with respect to the minimum standard deduction at any time within the period in which they can amend their tax return, that is, generally within the period ending 3 years after the due date filing for a given return.

(c)(i) *Effective date.*—Generally, the minimum standard deduction applies to taxable years ending after December 31, 1963. However, for taxpayers with fiscal years straddling this date, the bill provides for a portion of the benefits of the minimum standard deduction in the same way as rate reductions, in accordance with the number of days before and after December 31, 1963, in such years.

(d) *Revenue effect.*—The minimum standard deduction provided by this bill is expected to reduce revenues in a full year of operation by $320 million.

3. Amendments related to individual income tax rate reductions (sec. 113 of the bill and secs. 37 and 871 of the code)

(a) *Retirement income credit.*—Present law provides a tax credit on retirement for passive investment or pension income received by persons generally over age 65. However, the income taken into account for this credit must be reduced for tax exempt social security or railroad retirement income, and for those under age 72 for income derived from work above a specified income level. In computing the credit, present law provides that the income eligible for the credit is to be multiplied by the "rate provided in section 1 for the first $2,000 of taxable income." Under present law, this rate is 20 percent. Under both the House and committee bill, however, since this bracket has been split into four brackets, there are four rates ranging from 14 to 17 percent, applicable to different segments of this first $2,000 of taxable income.

The bill provides that the rate of tax to be used in computing this credit in the future is to be 15 percent. This is as near the middle of the four rates applicable to the first $2,000 of income as is possible, without the use of fractional rates.

(b) *Tax on nonresident aliens.*—Under present law, nonresident aliens receiving income from sources within the United States, such as interest, dividends, rents, salaries, wages, etc., are taxed on this income at a flat 30-percent rate (unless applicable tax treaties provide some other rates). However, present law also provides that if the nonresident alien receives more than $15,400 from the specified sources within the United States, then the regular individual income tax will apply with respect to the nonresident aliens' income from sources within the United States (if this results in a higher tax than the flat rate 30-percent tax).

The income level of $15,400 in present law is the point at which a 30-percent flat tax rate with one exemption would be likely to approximate the regular income tax rate with exemptions and with progressive rates. Because of the rate reductions provided by the bill, this income level of approximate equality rises, and has been established in the bill at $21,200.

4. Corporate rate reductions (sec. 121 of the bill and sec. 11 of the code)

Under present law, the total, or combined, corporate income tax rate is 52 percent. It consists of a 30-percent normal tax rate, applying to all corporate income, and a 22-percent surtax rate applying to corporate income in excess of $25,000. Thus, corporations are

taxed at a 30-percent rate on the first $25,000 of their taxable income and at a 52-percent rate on their taxable income above that level.

The House and committee bill makes two basic changes in the rate structure provided by present law. First, it lowers the overall rate from 52 to 50 percent for 1964, and to 48 percent for 1965 and subsequent years. Second, it "reverses" the normal and surtax rate in order to provide greater relief for small business. Thus, it provides that the normal tax rate is to be 22 percent instead of 30 percent for 1964 and subsequent years. The surtax rate then, for 1964, is to be 28 percent, and for 1965 and subsequent years, 26 percent. Thus, the bill provides a tax rate of 22 percent (in place of 30 percent) on the first $25,000 of a corporation's taxable income for both 1964 and subsequent years and a tax rate of 50 percent in 1964 and 48 percent in 1965 and subsequent years for the portion of a corporation's income over $25,000 (in lieu of the present 52-percent rate).

This reduction in corporate rates is important because it reverses the trend toward higher and higher corporate rates and also because it again makes the Government a "junior," rather than "senior," partner in any venture a corporation may undertake, insofar as the sharing of corporate income before tax is concerned. This tax rate reduction should be an important factor in improving the rate of profitability for corporations and, therefore, should provide an incentive for business investment and economic modernization and growth. It should also aid corporations in the export market in competing with corporations in other countries, where the corporate rates may not be as high as in the United States.

This tax cut for corporations, when fully effective, will amount to $2.2 billion a year. It should, of course, be viewed in connection with the reduction provided by Congress in 1962 in the form of an investment credit and the reform provided in 1962 in the depreciation guidelines. These taken together provide corporations with a tax reduction of approximately $4¼ billion.

The "reversal" of the corporate rates should be a substantial benefit to small business. The substitution of a 22-percent rate for the 30-percent rate represents a rate reduction of nearly 27 percent on the first $25,000 of income, as contrasted to the rate reduction for income above $25,000 of slightly less than 8 percent. Moreover, as indicated in table 9, the benefit of this rate reduction on the first $25,000 of income is appreciable for income levels up to $100,000.

TABLE 9.—*Revenue effect* [1]

Surtax net income class (dollars)	Number of taxable corporations	Computed tax liability, present rates [2] (million)	Normal tax to 22 percent and combined rate to 48 percent	
			Amount of reduction (million)	Percent reduction
0 to 25,000	467,500	$874	$233	26.7
25,000 to 50,000	54,000	636	126	19.8
50,000 to 100,000	25,000	759	94	12.4
100,000 to 1,000,000	25,500	3,427	290	8.7
1,000,000 and over	4,000	18,664	1,438	7.7
Total	576,000	24,360	2,190	9.0

[1] At 1963 levels of income.
[2] Excluding capital gains presently taxed at the alternative rate.

Your committee agrees with the House that it is important to provide a greater rate reduction for small businesses because of their importance in maintaining competitive prices in our economy, and also because of the greater difficulty small businesses have in finding outside funds to finance their expansion. As a result, they have traditionally found it necessary to expand largely out of income remaining after tax.

The rate reductions provided by the House and your committee for corporations apply to taxable years beginning after December 31, 1963, in the case of the reversal of the normal and surtax rates and also in the case of the reduction of the general rate to 50 percent. The reduction in the corporate rate from 50 to 48 percent applies to taxable years beginning after December 31, 1964. For fiscal year taxpayers, with years straddling either of these two dates, the bill provides that the reductions are to be prorated in accordance with the portion of the corporate year occurring after December 31, 1963, or after December 31, 1964.

The decrease of corporate rate from 52 to 50 percent in the calendar year 1964, and the reversal of the normal and surtax rates, is expected to decrease corporate tax liabilities for that year by $1.3 billion. The reduction in corporate tax liabilities for the calendar year 1965 and subsequent years (when the corporate rate will be further reduced to 48 percent) is expected to amount to $2.2 billion. This estimate is cumulative and includes the $1.3 billion loss referred to with respect to 1964 corporate tax liabilities.

5. *Current tax payments by corporations (sec. 122 of the bill and secs. 6074 and 6154 of the code)*

(*a*) *Present law.*—Under present law a calendar year corporation is required to pay 25 percent of its estimated tax in excess of $100,000 in the third quarter of the year in which the tax liability actually arises, or on September 15. Another one-fourth of this estimated tax is paid in the fourth quarter of the year of liability, or on December 15. The remainder of the tax is paid in two equal installments in the following year, the first installment being due at the same time as the tax return for that year, or on March 15, and the second and final installment being due on June 15. Comparable dates are provided for fiscal year corporations.

This system of paying two quarterly installments with respect to tax liability in excess of $100,000 in the same year in which the liability arises, was initially provided at the time of the adoption of the Internal Revenue Code of 1954. Before that time Congress had, in 1950, provided, in the case of calendar year corporations, that the tax was to be paid in two installments of 50 percent each on March 15 at the time for filing the return and on the following June 15, both of these payment dates being in the year immediately following the year in which the tax liability arose. (Comparable dates were provided for fiscal year corporations.) Prior to 1950, corporate taxes were payable in four installments of 25 percent each, the first two for calendar year corporations being on the dates specified above, and the last two on the following September 15 and December 15—both dates being in the year following the year in which the tax liability arose.

(*b*) *General reasons for provisions.*—As indicated above, corporations presently are only on a partial pay-as-you-go basis. Individuals, on

the other hand, either through withholding or through declarations, are on a full pay-as-you-go basis. Both the House and your committee, with respect to tax liability in excess of $100,000, place corporations on essentially the same pay-as-you-go basis as is already true in the case of individuals. This is to be accomplished gradually over a 7-year period. With the corporate rate reduction also provided by this bill, spreading the acceleration in corporate payments over this 7-year period can be accomplished without raising any corporation's income tax payment above its tax for 1963 (assuming the same income level throughout).

At the present time, the larger corporations appear to have sufficient funds to meet their investment requirements. In fact, many of the larger corporations customarily fund their tax liabilities by investing currently in Treasury tax notes or other types of short-term debt. Moreover, the cash and other liquid assets of corporations in 1962 amounted to $68.5 billion, or some five times the aggregate tax liability of these corporations. In any event, since in each year the acceleration in payments is offset or more than offset by the tax reduction, the speedup of corporate payments will not decrease internal funds available at the corporate level for investment. At the same time, the reduction in the rate of corporate tax will increase the profitability of investments, thus encouraging further expansion.

Since the acceleration of the corporate payments has no effect if tax liabilities are $100,000 or less, the smaller corporations which, in many cases, may have a shortage of internal funds available for investment, will not be affected by this provision. Such corporations will have additional funds available for investment through the general 4 percentage point corporate rate cut, and more especially through the 8 percentage point reduction in the tax applying to the first $25,000 of income.

(c) *General explanation of provision.*—Over the 7-year period, 1964 through 1970, the House and the committee bill, in effect, provides, in the case of calendar year corporations, that the two installment payments due on March 15 and June 15 of the year following the year of liability are to be advanced to April 15 and June 15 of the year of liability, leaving the September 15 and December 15 installment payments of 25 percent still due at the same time as under present law. (A comparable advance is made for fiscal year corporations.) Any liability, to the extent that it is not paid by estimated tax payments (for example, does not exceed $100,000), will still be payable in two installments after the close of the year of liability, on March 15 and June 15, in the same manner as under present law. The following tabulation shows the change in the percentage payment dates from present law to the system set forth in the bill when it is fully effective in 1970 and subsequent years:

	Percentage payments	
	Present law	Under bill when fully effective in 1970
Payments in year of liability:		
Apr. 15	0	25
June 15	0	25
Sept. 15	25	25
Dec. 15	25	25
Payments in year following year of liability:		
Mar. 15	25	(1)
June 15	25	(1)

[1] Payments will still be due on these 2 dates with respect to tax liability on the 1st $100,000 of tax and on any amount of underestimates.

The advance in corporate payments described above is achieved under the bill over a 7-year period, commencing in 1964, with respect to tax liabilities arising in that year. For corporations with tax liabilities in excess of $100,000, the bill requires that they make first and second quarterly current payments of 1964 tax in excess of $100,000 of 1 percent in April and June of 1964 (assuming they are calendar year corporations), with these quarterly percentages increasing to 4 percent in 1965, 9 percent in 1966, 14 percent in 1967, 19 percent in 1968, 22 percent in 1969, and then 25 percent in 1970 and subsequent years. These percentages apply only with respect to the portion of the corporations' tax liabilities which exceed $100,000. This gradual shift of the corporate tax payments, with respect to tax liability above $100,000, can perhaps best be seen by the following tabulation.

	Percent of estimated tax to be paid on the 15th day of the—				Percent of tax to be paid on the 15th day of—	
	4th month	6th month	9th month	12th month	3d month	6th month
	of the year of liability				of the year following the year of liability	
1964	1	1	25	25	24	24
1965	4	4	25	25	21	21
1966	9	9	25	25	16	16
1967	14	14	25	25	11	11
1968	19	19	25	25	6	6
1969	22	22	25	25	3	3
1970 and any subsequent year	25	25	25	25	(1)	(1)

[1] Payments will still be due on these 2 dates with respect to tax liability on the 1st $100,000 of tax and on any amount of underestimates.

The percentages of the tax liabilities to be accelerated for each of the years 1964 through 1970 were selected so that the speedup in corporate payments would not exceed the reduction in tax liabilities provided by the bill. The effect of the speedup on corporate tax liabilities for a calendar year corporation having a $10 million tax liability is shown in table 10. As indicated by this table, the combined effect of the rate reduction with the acceleration of corporate payments in all years results in a net reduction in tax payments, even for a corporation with a taxable income of $10 million. Corporations with smaller incomes would fare still more favorably in this respect.

The present provisions exempting corporations from any additional charges for failure to comply with the provisions of the declarations of estimated tax are continued as under present law. Present law provides an additional charge equal to 6 percent per annum for underpayments only if the estimated tax payments fail to come under one of the following four categories:

(1) they amount to 70 percent of the tax shown on the final return after subtracting $100,000 and allowing credits;

(2) they amount to as much as the previous year's tax reduced by $100,000;

(3) they are equal to what last year's tax (less $100,000 and allowable credits) would have been had current rates been applicable to that year's income; or

(4) the installment with respect to the declaration for any quarter is equal to 70 percent of the tax (less $100,000 and allowable credits) due on the basis of the income received to date, placed on an annual basis.

TABLE 10.—*Example of the combined effect on a calendar year corporation of current tax payments and the tax rate reductions provided by the bill (corporation assumed to have $10 million of taxable income and to base its estimates on 75 percent of this income*[1]*)*

Calendar year	Corporation payments		Calendar year	Corporation payments	
	Dollars	Percent of 1963		Dollars	Percent of 1963
1963	5,194,500	100.0	1968	5,145,513	99.1
1964	5,192,332	99.9	1969	5,004,707	96.3
1965	5,126,402	98.7	1970	5,004,707	96.3
1966	5,145,512	99.1	1971	4,793,500	92.3
1967	5,145,513	99.1			

[1] Your committee's bill provides for (1) a reduction of the normal tax rate to 22 percent in 1964; of surtax rate of 28 percent in 1964 and 26 percent in 1965; and (2) 1st and 2d quarter current payments in 1964 and 6 succeeding years of 1, 4, 9, 14, 19, 22, and 25 percent.

(*c*)(*i*) *Effective date.*—The changes described above with respect to the acceleration of corporate tax payments start in taxable years beginning after December 31, 1963, and will become fully effective for taxable years beginning after December 31, 1969.

(*d*) *Revenue effects.*—It has been estimated that this proposal will increase revenues in the fiscal year 1964 by $260 million and in the fiscal year 1965 by $900 million.

IV. GENERAL EXPLANATION

B. STRUCTURAL CHANGES

1. Dividend credit and exclusion (sec. 201 of the bill[1] *and secs. 34 and 116 of the code)*

(*a*) *Present law.*—Under present law, individuals are allowed to exclude from their tax base the first $50 of dividend income. If a husband and wife each have dividend income (or if they have such income jointly), the exclusion claimed on a joint return may amount to as much as $100 of dividend income. In addition, under present law, a credit of 4 percent is allowed against tax for any dividends

[1] The parenthetical references to the bill are to the bill as amended by your committee.

remaining after the $50 or $100 exclusion. This credit may not, however, exceed 4 percent of taxable income.[2]

(*b*) *General reasons for provision.*—In 1954 when the present dividend credit and exclusions were adopted, the committee report indicated that these relief measures were provided because the earnings of a corporation are taxed twice, once as corporate income and again as dividend income when paid out to the shareholders. It was stated that in addition to this being a double tax on this type of income, it also was a deterrent to investment in corporations. The report in 1954 partcularly stressed the effect of the penalty of double taxation in channeling investments in the form of indebtedness rather than equity capital or stock.

In fact, the reduction in the corporate rate by 4 percentage points provided by this bill probably does as much to remove any double taxation involved with respect to corporate distributions as would the continuance of the present 4 percent dividend credit. Moreover, from the standpoint of making funds available for investment in corporate enterprises, this reduction in tax with respect to retained earnings can be expected to have a more important impact on corporate investment than any reduction directed solely toward corporate income which is distributed. This greater encouragement for corporate investment has been provided not only by the corporate rate cut in this bill, but also by the investment credit allowed with respect to business investment in the Revenue Act of 1962. The House and your committee's action in this bill, in making this investment credit available without reduction in the depreciation base, provides still further inducements for business investment.

In addition, the notion that the dividend credit would encourage equity financing does not seem to be borne out by the events which have occurred since 1954. The Secretary of the Treasury has pointed out that the ratio of equity to debt financing by corporations has not increased despite the presence of the 4-percent credit.

The form of the present dividend credit, in any event, is undesirable since it reduces any double taxation by a much larger percentage for the higher income bracket stockholders than it does for those in the lower bracket. Information presented by the Secretary of the Treasury indicated that the dividend credit, even combined with the present exclusion, reduces the extra burden of double taxation by 10.4 percent in the highest income bracket, while reducing it by only 4.3 percent for those subject to the first bracket rate.

In view of these considerations, your committee agreed with the House that it would be better to concentrate relief from any double taxation which it is possible to provide in a dividend exclusion rather than in a dividend credit. The dividend exclusion, in the area operative, completely removes any double taxation. Moreover, increasing the exclusion, as the bill provides, will tend to encourage a broader stock ownership among those with relatively low income. At the same time, the repeal of the credit removes the discrimination in present law in favor of high bracket shareholders. Furthermore, removing the credit even though doubling the exemption available has the effect of raising $300 million of revenue in the calendar year

[2] The dividend exclusion and credit are not allowed for dividends received from foreign corporations, China Trade Act corporations, exempt corporations, corporations deriving most of their income from U.S. possessions, real estate investment trusts, life insurance dividends, dividends from mutual savings banks, domestic building and loan associations, etc., and capital gains dividends from regulated investment companies.

1965 and subsequent years, which in the bill is devoted to further individual income tax rate reductions than would otherwise be possible.

(*c*) *General explanation of provision.*—In view of the considerations referred to above, the bill, both as passed by the House and as approved by your committee, decreases from 4 to 2 percent the credit against tax allowed for dividends received during the calendar year 1964. With respect to dividends received in 1965 and subsequent years, the credit is repealed altogether. Consistent with the treatment provided when the tax credit was 4 percent of the dividend income, the dividend credit allowable during the calendar year 1964 is to be limited to 2 percent of taxable income received by an individual during that year.

The bill provides that with respect to dividends received in the calendar year 1964 and subsequent years the maximum exclusion per individual with respect to dividends received from a domestic corporation is to be $100, in lieu of the $50 available at the present time. In the case of married couples, where each owns stock separately or where stock is owned jointly and joint returns are filed, the maximum exclusion will be $200 in place of the $100 applicable under present law.

(*c*)(*i*) *Effective date.*—As indicated above, the dividend credit is reduced from 4 percent to 2 percent with respect to dividends received in the calendar year 1964 and is repealed with respect to dividends received in 1965 and subsequent years. The dividend exclusion is doubled with respect to amounts received in the calendar year 1964 and subsequent years.

(*d*) *Revenue effect.*—The combined effect of the reduction and then repeal of the credit and the increase of the exclusion is expected to increase tax liabilities by about $120 million for the calendar year 1964 and by $300 million in the calendar year 1965 and subsequent years when the repeal of the credit becomes fully effective.

2. Limitation on retirement income (sec. 202 of the bill and sec. 37 of the code)

(*a*) *Present law.*—Present law provides a retirement income credit which in general terms is designed to provide a credit against tax for those making provision for their retirement other than through social security, or railroad retirement or other tax-exempt income, and it is intended that this credit be approximately equal in value to the exclusions provided in the case of social security, etc. Thus, the maximum amount of income with respect to which a retirement income credit may be taken is geared to the maximum social security payment. Moreover, the credit is based upon the amount of pension or investment income of the individual involved, on the general principle that this represents the retirement base built up by those not covered by social security, etc. (or not covered to any appreciable extent). For the same reasons, the amount of income upon which the credit is based is reduced for any tax-exempt social security, railroad retirement, or other similar income received by the individual.

In addition, what amounts to a "work clause" applies to the retirement income credit to make it comparable to social security payments which also are reduced for earned income received by the individual above a specified level. The reduction for earned income in the case of the retirement income credit generally is a reduction of 50 percent for any earned income above $1,200 but not above $1,700, and a 100 percent reduction for any earned income above $1,700.

Social security and the retirement income credit also are correlated in the earnings requirement. To be covered for social security tax purposes, an individual generally must have a minimum coverage of 40 quarters or 10 years, assuming he has been in covered employment for a sufficient period of time. On the same basis, the retirement income credit provides that an individual to be eligible for the retirement income credit must have had 10 years of prior earnings experience, in each year of which he earned in excess of $600. For this requirement a widow or widower may use the earnings experience of the deceased spouse in much the same way as is provided in the case of social security benefits.

(*b*) *General reasons for provision.*— The attention of your committee was called to the fact that in one respect the retirement income credit is not coordinated with the social security program. Under the old age and survivors insurance program, if a husband has the appropriate 40 quarters of coverage but the wife does not, nevertheless, the payment may be made not only with respect to the husband directly but also a supplementary payment of one-half the size of the payment going to the husband may also be made with respect to the wife. The retirement income credit, on the other hand, contains no supplementary payment with respect to a spouse where that individual does not have the requisite prior 10 years' earnings experience. To provide a retirement income credit of one-half the size of that going to the primary wage earner in the family in such a case is the purpose of the amendment added by your committee.

(*c*) *General explanation of provision.*—Your committee has added a new subsection to the existing retirement income credit provision to provide that where the husband and wife have both attained the age of 65 before the close of the year, the maximum income on which the credit may be based is to be increased above the present ceiling of $1,524 by $762, or one-half of the present maximum. This is designed as the equivalent of the supplementary benefit going to a wife under the old age and survivors insurance program.

Where only one spouse has the requisite 10 years' prior earnings experience and receives an increase in his retirement income of $762, this amount is to be reduced by any social security, railroad retirement, or other tax-exempt pension income received by the spouse without the prior earnings experience. In addition, this $762 is to be decreased by any earned income this spouse is currently receiving in excess of $1,200 (on a 50-percent basis with respect to income between $1,200 and $1,700) assuming this spouse has not reached the age of 72.

If one spouse does not have 10 years' prior earnings experience, then the maximum base retirement income of the other spouse is increased by the full $762 (with certain reductions referred to later). On the other hand, if both husband and wife have the requisite 10 years' prior earnings experience and if one of them has less than $762 of retirement income, then the maximum of $1,524 with respect to the other spouse is to be increased to the extent that the retirement income of the other spouse is less than $762. Computations, similar to the reductions referred to above where only one spouse has the ten years prior earnings experience, are required here with respect to tax-exempt income and earnings above the specified levels.

It should be noted that increasing a spouse's maximum allowable retirement income by the $762, or any part of this amount, does

not of necessity mean a larger retirement income credit. Whether he can receive a larger retirement income credit in such a case depends upon whether or not he receives sufficient qualifying investment and/or pension income to reach this new ceiling level, which may be as high as $2,286. The credit allowable is 15 percent of this amount.

(*c*)(*i*) *Effective date.*—This increase in the retirement income credit applies to taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—It is anticipated that this will result in an annual revenue loss of $10 million a year.

3. *Investment credit: Repeal of provision reducing basis of property by 7 percent and other amendments (sec. 203 of the bill and secs. 48 and 1245 of the code)*

(*a*) *Present law.*—Last year in enacting an investment credit, Congress in general allowed a credit equal to 7 percent of certain types of investment (3 percent in effect in the case of most public utilities). This amount may be offset in full against tax liability up to $25,000 and against one-quarter of the tax liability above this level. Property with an estimated useful life of 8 years or more is fully taken into account in computing this credit, property with an estimated life from 6 to 8 years is taken into account at two-thirds of its cost, while property with an estimated life from 4 years up to 6 years is taken into account at one-third of its cost. The credit for the most part is limited to purchases of tangible personal property. As a result, machinery and equipment are the principal types of investment eligible for the credit.

As finally enacted in the Revenue Act of 1962, it was further provided that the base on which depreciation may be taken in the case of assets eligible for the investment credit was to be reduced by the amount of the credit. Thus, for example, where a taxpayer purchased a $100 asset and $7 of this purchase price was allowed as an investment credit, the basis on which depreciation could be computed with respect to the asset was decreased from $100 to $93.

(*b*) *General reasons for provisions.*—Although the investment credit enacted last year appears to have been successful in stimulating investment, several problems have arisen with respect to this credit which are dealt with in this bill.

First and most important of the changes made is the repeal of the requirement that the basis of property eligible for the investment credit be reduced by 7 percent of the qualified investment. This provision requires that if property costing $100 and eligible for an investment credit of $7 was acquired, the basis of this property for purposes of depreciation (or gain or loss on sale) was to be reduced from $100 to $93.

This provision has proved troublesome to taxpayers since it requires a downward basis adjustment with respect to eligible property, whether or not an investment credit is claimed for the property. Moreover, making this adjustment has presented recordkeeping problems for taxpayers, especially in the case of early retirements, and also severely complicated the statutory language of the investment credit provision.

In addition, this basis adjustment for property severely restricted the incentive effect of the investment credit. In effect, this amendment converted the 7-percent credit into a 3¼-percent credit for corporations, plus a 7-percent initial depreciation allowance. This

result occurs because the decrease in basis of the asset which may be written off means that the equivalent of approximately one-half of the investment credit is recouped over the life of the asset in substantially the same manner as an initial depreciation allowance. This effect substantially reduces the incentive effect of the credit, since it means that approximately half of the benefits must be restored over the useful life of the asset. In effect, this transforms one-half of the credit into an interest-free loan.

To remove the recordkeeping and accounting problems which have arisen in connection with the basis adjustment provision and also to provide a greater stimulus with respect to the investment credit, the bill, both as passed by the House and as reported by your committee, repeals this basis adjustment provision. It also provides a means whereby over a period of time taxpayers may recoup their basis adjustments already made.

A second problem presented with respect to the investment credit arises in determining the amount of the credit in certain situations in the case of leased property. Under present law a lessor may pass on the benefits of any investment credit with respect to his purchases or other acquisitions to the lessee of the property. This was provided on the grounds that it was the lessee in such cases who was creating the additional market for investment. The existing provision in this respect provides that the amount of the investment credit, if the property is constructed by the lessor, is to be the appropriate percentage of the "fair market value" of the property. However, in all other cases involving leases the investment credit is to be the appropriate percentage of the basis of the property to the lessor. In practice, this has discriminated in favor of manufacturers of equipment relative to independent distributors. Thus, in the case of equipment leased by the manufacturer having a fair market value of $1,000 the investment credit passed through to the lessee in this case will be 7 percent of $1,000 or $70. However, if the same equipment is purchased from the manufacturer by an independent distributor at a dealer's discount of perhaps 25 percent, the basis of the property to the dealer would be $750. Thus, he could pass on an investment credit of only $52.50 instead of the $70. As a result, it is more advantageous for customers to lease the property directly from manufacturers, rather than from independent distributors. Both the House and your committee's version of the bill removes this discrimination by basing the credit in both cases upon the fair market value of the property.

A third problem arises with respect to the treatment of escalators and elevators in the case of the investment credit. Among the categories of property not eligible for the investment credit are buildings and their structural components. Your committee's report indicated that the term "structural components" of a building included such parts of a building as central air conditioning and heating systems, plumbing and electric wiring and lighting fixtures relating to the operation and maintenance of the building. The proposed regulations issued by the Treasury Department with respect to the term "structural components" provide an extensive list of the type of items considered to be structural components and therefore not eligible for the investment credit. Among these items are escalators and elevators. While these regulations are an accurate interpretation of the intention of Congress last year in this respect, nevertheless your committee

agrees with the House that it is appropriate to reconsider the treatment of escalators and elevators for purposes of the investment credit. Escalators and elevators are closely akin to assets "accessory to the operation" of a business which presently are eligible for the investment credit. These assets include machinery, printing presses, transportation or office equipment, refrigerators, individual air-conditioning units, grocery counters, etc. In addition, new elevator and escalator equipment represents an important aspect of modernization of plant and facilities.

For the reasons cited above, the bill provides that new elevators and escalators installed after June 30, 1963, and modernization of existing elevators after that date should be eligible for the investment credit. This, of course, also means that elevators and escalators will be treated as coming under the recapture provision enacted in 1962. This in general provides that depreciation deductions taken with respect to such equipment in the future are to give rise to ordinary income to the extent of any gain recognized on the sale of such property.

A fourth modification in the investment credit relates to the treatment of the credit by regulatory bodies. Both the House and Senate committee reports on the investment credit, as well as the statement of the managers on the part of the House with respect to the conference (and the floor statement on the Senate with respect to the conference report) state that the purpose of the investment credit was to stimulate investment by reducing the net cost of acquiring depreciable assets. This is shown by the following quotations. First, in the report of the Committee on Ways and Means of the House on that bill:

> The investment credit will stimulate investments because—as a direct offset against the tax otherwise payable—it will reduce the cost of acquiring depreciable assets. This reduced cost will stimulate additional investment as it increases the expected return from their use. The investment credit will also encourage investment because it increases the funds available for investment. * * *

In the report of your committee on that bill it was stated:

> The investment credit will stimulate investment, first by reducing the net cost of acquiring depreciable assets, which in turn increases the rate of return after taxes arising from their acquisition. * * *
>
> The objective of the credit is to reduce the net cost of acquiring new equipment; this will have the effect of increasing the earnings of new facilities over their productive lives and increasing the profitability of productive investment. It is your committee's intent that the financial assistance represented by the credit should itself be used for new investment, thereby further advancing the economy.

Again, in the statement of the managers on the part of the House with respect to the conference committee, and also in the floor statement of the manager of the bill in the Senate, it was stated:

> It is the understanding of the conferees on the part of both the House and Senate that the purpose of the credit for investment in certain depreciable property, in the case of both regulated and nonregulated industries, is to encourage mod-

> ernization and expansion of the Nation's productive facilities and to improve its economic potential by reducing the net cost of acquiring new equipment, thereby increasing the earnings of new facilities over their productive lives.

Despite the statements cited above, the Federal Communications Commission has indicated that it is its policy that any benefits from the investment credit made available by the Revenue Act of 1962 should "flow through" immediately to the customers. In addition, the staff of the Federal Power Commission has recommended the same position. This is clearly contrary to the intent of Congress in enacting this provision and as a result this bill contains a provision to the effect that it was and is not Congress' intention that the Federal regulatory agencies require the benefit of the investment credit to "flow through" in this manner.

(*c*) *General explanation of repeal of basis adjustment provision.*—In the case of property placed in service after December 31, 1963, the bill, as amended by your committee, repeals the provision in existing law requiring a downward adjustment in the basis of property by 7 percent of the qualified investment. In the House bill the repeal of the provision was for property placed in service after June 30, 1963. This date was moved up by your committee because of the later consideration of the bill by your committee.

In addition, the bill provides that the basis of property eligible for the investment credit which was placed in service before January 1, 1964 (July 1, 1963 under the House bill), is to be increased by 7 percent of the qualified investment for such property, as of the first day of the taxpayer's first taxable year beginning on or after that date—January 1, 1964, with respect to a calendar-year taxpayer.[1]

Where the lessor passed the benefit of the investment credit on to the lessee, present law provides that the deductions allowed to the lessee for payments to the lessor under the lease contract are to be adjusted downward to reflect an amount similar to the amount of basis denied in the case of other than lease property. The bill provides that where this has occurred the Treasury is to provide for upward adjustment in the deductions allowed to the lessee for amounts paid to the lessor to similarly reflect the restoration of basis adjustments in these cases.

The effect of the provisions described above is to provide for no downward adjustment in basis with respect to property placed in service after December 31, 1963 (June 30, 1963, under the House bill). With respect to property placed in service before that time but in 1962 or 1963 and still on hand at the beginning of the taxpayer's first year beginning after that time (January 1, 1964, in case of calendar-year taxpayers) the basis on which depreciation is taken (or gain or loss in the case of sale) for property which was eligible for the investment credit is to be increased by the same 7 percent by which the basis was reduced when the property was acquired. This addition to basis in the case of those computing depreciation on a straight-line basis will be recouped ratably by the taxpayer over the remaining life of the assets. In the case of double declining balance depreciation the recoupment will occur somewhat more rapidly. This method of handling the

[1] The restoration of basis referred to above is to be reduced with respect to any previous restoration which may have arisen because the property was no longer eligible for the investment credit or because of conversion of industrial property to public utility use, therefore no longer being eligible for the full investment credit.

restoration of the basis in the case of previously acquired investment credit assets makes the taxpayer "whole" without the necessity of refunds.

(*c*)(*i*) *Credit for leased property to lessee.*—As indicated above, present law provides that when the investment credit is passed through from the lessor to the lessee the investment credit is to be based on the fair market value of the property if the property was constructed by the lessor, but otherwise is to be determined from the basis of the property to the lessor. The House and your committee's bill provides that the investment credit in these lease cases is to be based on the fair market value of the property, whether or not the lessor created the property. An exception to this rule is provided, however, where the property is leased by a corporation which is a member of an affiliated group to another member of the same affiliated group. In this latter case, since there is no lease to an "outsider," the investment credit will still be determined on the basis of the cost of the property to the lessor. This amendment applies to property, the possession of which is transferred to a lessee on or after the date of enactment of this bill.

(*c*) (*ii*) *Treatment of elevators and escalators.* Elevators and escalators have not, up to this time, been eligible for the 7-percent investment credit, since they have been classified as structural components of a building which specifically were not eligible for the investment credit. Both the House and your committee's version of the bill, however, modifies this rule. It provides in the case of elevators and escalators that where their construction, reconstruction or erection is completed after June 30, 1963, or the elevator or escalator is new in the hands of the taxpayer and is acquired after that date, then the cost of the elevator or escalator (or a reconstruction) is to be eligible for the investment credit.

In view of the fact that the investment in elevators and escalators is to be eligible for the investment credit, they also are to be treated as subject to the recapture provision (sec. 1245) enacted by Congress in 1962. However, only depreciation deductions taken with respect to periods after June 30, 1963, are to be subject to this ordinary income recapture where the elevator or escalator subsequently is sold at a gain (and then only to the extent of this gain are these depreciation deductions to be treated as ordinary income). This provision applies only to elevators and escalators sold after December 31, 1963.

(*c*)(*iii*) *Treatment of investment credit by Federal regulatory agencies.*—Another investment credit provision in the bill makes it clear that it was the intent of Congress in providing an investment credit in 1962, and that it is the intent of Congress this year in repealing the reduction in basis required with respect to investment credit assets, to provide an incentive for the modernization and growth of private industry, including regulated industries.

As a result, the bill specifies in two paragraphs the intent of Congress as to the treatment of the investment credit by Federal regulatory agencies. It states in the case of public utility property that these regulatory agencies are not, without the taxpayer's consent, for the purpose of establishing the cost of service of the taxpayer, to treat more than a proportionate part of an investment credit (determined with reference to the useful life of the property) as reducing the taxpayer's Federal income tax liabilities. Nor are they to accomplish a

similar result by any other method. Public utility property for this purpose includes property of electric, gas, water, telephone, and telegraph public utilities which under present law is eligible for what in effect amounts to a credit of 3 percent.

The bill also provides restrictions for Federal regulatory agencies in the case of other regulated companies—such as natural gas pipelines, railroads, airlines, truck and bus operators, and other types of public carriers—which receive an investment credit of 7 percent of the investment in qualified property. It provides that Federal regulatory agencies are not, without the taxpayer's consent, for purposes of establishing the cost of service of the taxpayer, to treat any investment credit allowed him as reducing his Federal income taxes. Nor are the agencies to accomplish a similar result by any other method.

As indicated above in the case of the public utility property Congress is merely directing the Federal regulatory agencies not to "flow" the benefits of the investment credit "through" to the customers over any period shorter than the useful lives of the property involved. In the case of the other property Congress is directing the Federal regulatory agencies not to "flow" this benefit "through" at any time. This difference in treatment is attributable to the fact that Congress provided what in effect is a 3-percent credit for the public utility property rather than 7-percent credit because in 1962 it was recognized that in their case part of the benefit from the investment credit would be likely to be passed on eventually to the customers in lower rates.

(*c*)(*iv*) *Effective dates.*—As indicated previously, under your committee's amendments the repeal of the basis adjustment is to apply with respect to property placed in service after December 31, 1963. However, property placed in service before that time, with respect to which a basis adjustment has already been taken, if still in the hands of the taxpayer on the first day of his taxable year beginning after December 31, 1963, is to receive an upward adjustment in basis.

The amendment concerning the amount of the investment credit in the case of leased property is to apply with respect to property transferred to a lessee on or after the date of enactment of this bill. The amendment made with respect to escalators and elevators in the case of the investment credit applies to those acquired or constructed after June 30, 1963. The recapture rule with respect to these assets applies to dispositions of escalators or elevators after December 31, 1963.

(*d*) *Revenue effect.*—The repeal of the basis adjustment with respect to the investment credit is expected to reduce tax liabilities by $160 million in the calendar year 1964 and by $195 million in the calendar year 1965 with gradually greater reductions in successive years, according to Treasury estimates; estimates by the staff of the Joint Committee on Internal Revenue Taxation are $245 million and $305 million, respectively. Making elevators and escalators eligible for the investment credit is expected to result in an additional $10 million of loss in the calendar year 1964 and subsequent years.

4. Group term life insurance purchased for employees (sec. 204 of the bill and sec. 79 of the code)

(*a*) *Present law.*—Under present law, employees are required to include in their income the amount of premiums paid by their employers to provide them with individual life insurance or group

permanent life insurance which carries a loan or surrender value. However, the regulations (1.61–2(d)(2)) have provided that the cost of group term life insurance purchased for employees is not includible in their income as compensation although the employer receives deductions for the amounts he pays to provide this protection.

(*b*) *General reasons for provisions*.—As indicated above, this tax-free status for employer-financed group term life insurance is inconsistent with the tax treatment of other types of life insurance protection furnished employees by their employers. While this complete exclusion might have been considered relatively insignificant when tax rates were low, the present relatively high rates as well as the growing volume of group term life insurance now provided makes it particularly inequitable to continue this complete exclusion. The employee in such case receives a substantial economic benefit from this insurance protection whether or not the policy for a specific year leads to a payment to his beneficiary. The provision of this insurance by the employer relieves the employee of substantial costs of providing his own insurance protection for his family which he would otherwise have to provide out of tax-paid dollars.

The House, despite recognizing that the entire cost of this insurance protection represents compensation to the employee, provided an exemption with respect to the premiums paid on the first $30,000 of such insurance because it believed, from the standpoint of the economy as a whole, that it is desirable to encourage employers to provide life insurance protection for their employees. Provision of such a basic amount of insurance does much to keep together family units where the principal breadwinner dies prematurely. Your committee is in accord with the reasoning of the House on this subject but believes that $70,000 represents a more appropriate exemption level. It has also made three other more technical amendments described below.

(*c*) *General explanation of provisions*.—For the reasons given above, the bill as amended by your committee provides that the gross income of an employee for tax purposes is to include the cost of any group term life insurance provided him under a policy carried directly or indirectly by his employer to the extent that the insurance coverage provided is in excess of $70,000 as contrasted to $30,000 under the House bill. The employee will not be charged with any portion of this insurance protection over $70,000 which he provides himself through his own contributions, since insurance protection provided in this manner is paid for out of tax-paid dollars. Moreover, all contributions made by the employee are applied against insurance protection above the $70,000 exclusion level.

The cost of protection above $70.000 is taxed to an employee if it is provided under a plan arranged for by the employer whether the protection the employee receives (over and above that provided by his own contributions) is provided directly by the employer, or indirectly by the employer's charging more than the cost of the insurance to other employees (such as those in younger age brackets) and less to those in the older age brackets, such as the specific employee in question.

(*c*)(*i*) *Exception for retired employees, etc.*—Both the House and your committee's bill provides an exception to the general rule described above where the individual's employment has been terminated and either he has reached the normal retirement age (under the practice followed by his employer) or he has become disabled. In both of

these cases it was concluded that it would be undesirable to tax the aged or disabled individual who is no longer working for group term life insurance protection provided to him by his former employer.

Two other exceptions are also provided where the insurance protection provided by the employer will not be treated as compensation to the employee, even though in excess of the $70,000 coverage exclusion. First, it will not be taxed to the employee where the employer directly or indirectly is the beneficiary of the policy since in such cases the employer is in reality providing for his own rather than his employee's interest.

Secondly, the costs of the insurance protection in excess of $70,000 will not be taxed to the employee where the beneficiary of the policy is a charitable organization (of the type described in sec. 170(c) of the code). An exception is provided for such cases because it is recognized that where an employer provides protection for all of his employees, a few of them may not have natural heirs and, therefore, if left to their own choice, might not purchase insurance protection. It was concluded that in such cases, it would be unfair to tax such employees on the cost of insurance protection provided by employers. For this reason, it was thought that where the employee demonstrated his own personal disinterest in the protection by naming a charity as the beneficiary, no portion of the cost of such protection should be considered as income to him. It is not intended, however, that he receive any deduction for a charitable contribution with respect to such assignment.

(c)(ii) *Determining the cost of the insurance.*—The House bill provided that the cost of the insurance protection can be determined under either of two methods. Your committee's bill provides that this cost can be determined only under the first of these methods. Under both versions of the bill this cost can be determined by using a uniform table. In this case, the cost of the insurance is averaged out on the basis of 5-year age brackets, in order to simplify computations which must be made by the employer in informing the employee as to the amount of taxable income. Where cost is determined on the basis of this uniform table it will be determined on the basis of a table published in the Treasury Regulations on this provision.

This table will reflect costs of such protection based upon insurance company experience and, of course, will be changed from time to time as mortality experience or other factors indicate that this is appropriate. Until provided otherwise by regulation, however, the cost per $1,000 of group term life insurance protection can be determined from table 11 below.

TABLE 11.—*Uniform 1-year term premiums for $1,000 of life insurance protection*

[Cost per $1,000 of protection]

Age:	
15 to 19	$1.44
20 to 24	1.73
25 to 29	2.11
30 to 34	2.72
35 to 39	3.65
40 to 44	5.10
45 to 49	7.36
50 to 54	10.87
55 to 59	16.29
60 to 64 [1]	24.67

[1] Those age 65 and over whose employment is not terminated will also have their insurance cost computed on the basis of the 60 to 64 age category.

The second method which would be available under the House bill but not under your committee's amendments provides that an employer, in computing the cost of his employee's protection for tax purposes, may use the actual cost of the policy to him and the employees. In this case also, the same 5-year age brackets as provided under the uniform premium table would be used. Your committee's amendments remove this second method of computation because it has been informed that this method is difficult for employers to compute. Moreover, since the uniform premium table method of computation contains no loading charge, in almost all cases it will in any event result in the lower cost.

Both the House and your committee's version of the bill provides that in the case of employees (not retired), who are over age 64, the cost of protection is not to be increased in such cases, but instead is to continue to be computed on the same basis as those in the age bracket 60 to 64.

(c)(iii) *Deduction for certain contributions provided by House bill but not your committee's amendments.*—The House bill provided a special deduction in computing taxable income for contributions made by an employee toward the purchase of group-term insurance protection in excess of the cost of his own insurance (only above the exemption level). This deduction was provided by the House bill on the grounds that under some group-term insurance plans the younger employees in effect pay for insurance protection provided for those in higher age brackets. It was suggested that this usually occurs where a uniform rate of contribution is required of all employees regardless of age. In such cases, it was indicated that the cost of protection for those who are relatively young may not equal the contribution made by the employees. In view of this, the House bill provided that contributions made by an employee (above the exemption level) to the extent that they exceeded the cost of the protection provided for him were to be deductible by him for tax purposes. Your committee's amendment deletes this deduction. Your committee has taken this action primarily because it believes that the size of these deductions would in any event be relatively small and on the grounds that it is questionable whether these deductions are worth the added administrative burden they would bring for the employer.

(c)(iv) *Example of method of computation.*—To illustrate the method of computing the taxable cost of group term insurance provided under your committee's version of the bill, it is first assumed that the employee makes no contribution toward this protection himself, and then that he makes a contribution of $2 per $1,000 of coverage. The method of computing the inclusion in the employee's gross income is illustrated by an employee age 41 who is provided with $200,000 of group term life insurance protection.

Where employee makes no contribution

Portion of insurance coverage taken into account ($200,000–$70,000)	$130,000.00
Cost of insurance protection per $1,000 for individual age 41 assuming uniform premium table is used	5.10
Amount to be included in income tax base by employee ($5.10×130)	663.00

Where employee makes contribution

Portion of insurance coverage taken into account ($200,000–$70,000)	$130, 000. 00
Cost of insurance protection per $1,000 for individual age 41 assuming uniform premium table is used	5. 10
Total cost of insurance attributable to employee's contribution ($2.00×200)	400. 00
Cost of insurance protection above $70,000 exclusion ($5.10×130)	663. 00
Amount to be included in income tax base by employee ($663–$400)	263. 00

(*c*)(*v*) *Reporting instead of withholding.*—The House bill provides that the cost of group term insurance, to the extent taxable to the employees, is to be subject to regular income tax withholding. Your committee concluded that this was unnecessarily burdensome for employers, particularly in view of the fact that so few employees would be affected by the $70,000 exclusion level. Instead, your committee's bill provides for the reporting of this income annually by the employer to the Government, with a copy of the information return also going to the employee. The amount shown on this information return is only the amount payable with respect to an employee which represents taxable income to him. Where he is covered by more than one employer, each employer is to determine the exemption for purposes of the information return in the same manner as if he were the only employer. The type of information return (form 1099) is the same as that already used under existing law to report dividends and interest. The penalties for failure to provide the information are $10 per person unless the failure is due to reasonable cause rather than willful neglect. The total penalties paid by an employer may not exceed $25,000.

(*c*)(*vi*) *Effective date.*—The tax treatment provided with respect to group term insurance as described above is to apply with respect to such insurance protection provided after December 31, 1963. The information reporting with respect to this insurance will apply to remuneration paid after December 31, 1963, in the form of group term insurance provided after that date.

(*d*) *Revenue effect.*—It has been estimated that the enactment of the group term life insurance provision described above will result in an increase of somewhat less than $5 million in revenues in a year when this provision is fully effective.

5. Sick pay exclusion (sec. 205 of the bill and sec. 105(d) of the code)

(*a*) *Present law.*—Under present law amounts paid to an employee by his employer to continue his wage payments when he is absent from work because he is sick or injured are excludable from the employee's gross income under certain conditions (although deductible by his employer). The exclusion in any case is available only up to $100 per week. In the case of absence from work due to personal injuries, this $100 is the only limitation at the present time. In the case of sickness, however, the exclusion is available only after the first 7 days of absence, unless the employee is hospitalized because of the sickness for at least 1 day during his absence.

(*b*) *General reasons for provision.*—Your committee agrees with the House that this sick pay exclusion in its present form is not justified. The amounts received by the employee in this case are substitutes for regular wages or salaries which, had they been received as such, would

be fully taxable. The wage substitutes in this case are wholly unrelated to the costs involved as a result of illness or injury. Amounts paid by the employer for the medical expense of the employee already are excludable by the employee under other provisions of law (sec. 105(b)) and amounts paid by the employee himself for medical expenses also are deductible elsewhere under present law (sec. 213 of the code) to the extent that they exceed what is considered to be the normal level of medical expenses.

The present exclusion also tends to encourage malingering because it treats the employee who stays at home better than another employee; also is easily abused because an employee who stays home because of a minor injury or illness may obtain an exclusion substantially in excess of any additional expenses he may incur.

The House bill provided, however, that those who have become permanently disabled or who have had long, continuing illnesses or accidents could continue to receive the advantage of this provision. It was thought that persons are likely to have their earnings substantially decreased, at the same time they also may be faced with large medical bills. Moreover, in such cases, the ordinary family financial requirements are likely to continue at their usual level, presenting larger problems for the individual as the period of absence from work becomes longer. Your committee also is in accord with this reasoning, and therefore has continued this provision unchanged.

(*c*) *General explanation.*—For the reasons presented above the sick pay exclusion of present law is amended to provide that wage continuation payments are not to be excludable to the extent they are attributable to the first 30 days of absence because of personal injury or sickness. This means, of course, that this exclusion will be available after the first 30 days of injury or sickness for the long continuing illness and also in the case of those receiving permanent disability pensions before the normal retirement age.

Under present law employers who make wage continuation payments which are not excludable from the employee's income (e.g., payments in excess of $100 a week or payments for the first 7 days in the case of sickness where there is no hospitalization) are required to include these amounts in income subject to withholding and reporting on form W-2. This practice will be continued under the revised provision with the withholding and reporting applying to a larger proportion of the wage continuation payments. Where these payments are made by someone other than the employer, such as an insurance company or a pension trust, the Treasury does not presently require withholding and it is the intention of the House and your committee that this practice be continued. However, these payments are (if made on behalf of the employer) to be included on the W-2 form prepared by the employer and shown on this form as wages or salary.

(*c*)(*i*) *Effective date.*—The amendment made by this provision will apply to wage payments attributable to periods of absence commencing after December 31, 1963.

(*d*) *Revenue effects.*—It is estimated that the provision described above, when fully effective, will result in an increase in revenues of $110 million a year.

6. *Exclusion for gain on the sale of a residence by an individual age 65 or over (sec. 206 of the bill, sec. 121 of the code)*

(*a*) *Present law.*—Under present law (sec. 1034) where an individual sells his old residence and, within a year of that sale, purchases a new residence (or within 18 months thereafter builds a new residence), the gain on the sale of the old residence is not recognized to the extent that it, plus the cost or other basis of the old residence, is invested in the new residence. This postponement of the taxation of the gain is available only where the new residence is purchased or built within the time specified.

(*b*) *General reasons for the provisions.*—While present law generally provides adequately for the younger individual who is for one reason or another changing residences, it does not do so for the elderly person whose family has grown and who no longer has need for the family homestead. Such an individual may desire to purchase a less expensive home or move to an apartment or to a rental property at another location. He may also require some or all of the funds obtained from the sale of the old residence to meet his and his wife's living expenses. Nevertheless, under present law, such an individual must tie up all of his investment from the old residence in a new residence, if he is to avoid taxation on any of the gain which may be involved.

Your committee agrees with the House that this is an undesirable burden on our elderly taxpayers.

(*c*) *General explanation.*—For the reasons given above, the bill provides an exclusion from gross income for a limited amount of gain received from the sale or exchange of a personal residence in the case of taxpayers who have reached age 65 before the sale or exchange occurs. To be eligible for this treatment, they must have owned and used the property involved as their principal residence for 5 out of the last 8 years before the sale or exchange.

(*c*)(*i*) *Limitations.*—In this provision the primary concern is with the average and smaller homestead selling for $20,000 or less. For that reason, the application of this section is limited so that a full exclusion is provided only for the gain attributable to the first $20,000 of the sales price.[1] Where the sale price of the residence does not exceed $20,000, the entire gain is excluded from income for tax purposes. Where the sale price exceeds $20,000, a proportion of the gain is excluded. The proportion excluded is in the ratio of $20,000 to the actual sale price; for example, if a residence is sold for $60,000 and the gain is $10,000, then the portion of this $10,000 gain which will not be taxable is determined as follows:

Actual sale price	$60, 000
Ratio of $20,000 to sale price ($20,000/$60,000)	⅓
Proportion of $10,000 gain to be excluded from taxable income (⅓ of $10,000)	$3, 333. 33
Remaining gain subject to tax	$6, 666. 67

To prevent taxpayers over age 65 from reusing this section and obtaining numerous exclusions for gains on personal residences, the bill provides that this exclusion is available to a taxpayer and his spouse only once in their lifetimes.

[1] Actually the determination is made on the basis of adjusted sales price which as provided elsewhere in the code is the gross sales price less any so-called fix-up expenses incurred in selling the property. In this regard, see sec. 1034(b)(1).

(c)(ii) *Other rules.*—Since a taxpayer and his spouse may claim the exemption under this provision only once in their lifetimes, the bill provides that the exclusion is elective and may be made or revoked at any time before the expiration of the period for making a claim for credit or refund of tax, generally about 3 years after the year of the sale or exchange. It also was necessary to provide a number of other special rules for the application of this provision. These rules may be described briefly as follows:

1. Where property is held jointly by a husband and wife either as joint tenants, tenants by the entirety or as community property, if a joint return is filed by the husband and wife and one of them satisfies the age requirement of 65 and has held and used the property for the required 5 out of the last 8 years, then both the husband and wife are treated as meeting these requirements.

2. Where the spouse of an individual has died and that spouse held and used the property as a personal residence for 5 out of the last 8 years and had not previously claimed an exemption under this provision, then the individual who is still living will be treated as satisfying these holding and use requirements. (However, the surviving spouse must be age 65 for the exclusion to apply).

3. The bill provides that for purposes of this provision tenant stockholders in a cooperative housing corporation who sell their right to occupy the house or apartment are to be treated in the same manner for purposes of this provision as those who own their residence outright.

4. Any gain realized from the destruction, theft, seizure, requisition, or condemnation of a personal residence is to be eligible for this provision in the same manner as if the residence had been sold.

5. Where a part of a property is used as a personal residence and the remainder as a business or income producing property, the exclusion provided under this provision upon the sale of the property is to be available to the extent that the gain is attributable to the portion of the property owned and used by the taxpayer as his personal residence.

6. In applying this provision, an individual is to be considered as married or single according to his status on the date of the sale or exchange. An individual who is separated under a decree of divorce or separate maintenance on the date of the sale is not considered as married for purposes of this provision.

7. In the case of involuntary conversions and in the case of the sale or exchange of one personal residence for another, gain is not recognized under present law where the total amount realized from the conversion or sale is reinvested within a specified period of time. In addition, the basis of the new property so acquired in such cases remains the same (except for any additional investments over and above the sales price) as the property previously held. Where both the exclusion available for taxpayers over age 65 and either of these two provisions may be applied with respect to the same transaction, the bill provides that the exclusion for those over age 65 is to be applied first. Thus, in the case of the involuntary conversion or the sale of a personal residence and the purchase of another, by a taxpayer who is over age 65, any gain which might be realized upon the involuntary conversion or sale of the residence will be reduced by any exclusion available to the taxpayer under this section. In addition, in the case

where the total amount is reinvested within the specified period the basis of the taxpayer in the newly acquired residence will be his basis for the old residence increased by any exclusion of gain obtained by him under the provision which is reinvested in the new residence (and, of course, increased by any additional funds which he may have invested over and above the amount realized from the first residence).

8. In determining whether an individual has gross income of $600 or more (or $1,200 or more in the case of those over age 65) any exclusion provided under this provision will for that purpose alone be treated as gross income. This assures that the Government will receive proper reporting on amounts claimed as exclusions under this provision.

(*c*)(*iii*) *Effective date.*—This provision applies to sales, exchanges, and other dispositions after December 31, 1963.

(*d*) *Revenue effects.*—This provision is expected to result in an annual revenue loss of $10 million.

7. Denial of deduction for certain State, local, and foreign taxes (sec. 207 of the bill and secs. 164 and 275 of the code)

(*a*) *Present law.*—The general rule under present law is that taxes paid or accrued by a taxpayer are deductible for Federal income tax purposes. However, an exception to this rule provides that no deduction is to be allowed for certain specified taxes, principally Federal taxes. The categories of taxes which may not be deducted under present law are:

1. Federal income taxes.
2. Federal war profits and excess profits taxes.
3. Federal import duties and Federal excise and stamp taxes (except that these taxes may be deductible as business expenses or taken into account as expenses incurred in the production of income).
4. Estate, inheritance, gift, and similar taxes.
5. Most local improvement taxes.
6. Foreign income and excess profits taxes and similar taxes imposed by U.S. possessions (if the taxpayer elects to take a foreign tax credit for these taxes in lieu of a deduction).

The practical effect of the above listing of taxes is to deny any deduction for Federal taxes paid by the taxpayer (except to the extent that taxes listed in category 3 above qualify as business expenses or expenses incurred in the production of income).

State and local taxes on the other hand generally are deductible, except death and gift taxes and most local improvement taxes. The most important State and local taxes, and the revenues derived from them by State and local governments in 1961, are as follows:

1. Real and personal property taxes, $18 billion.
2. Income taxes, $3.9 billion.
3. General sales and gross receipts taxes, $5.4 billion.

The three categories of taxes indicated above account for $7.5 billion of the total $10 billion of taxes taken as nonbusiness deductions on taxable returns for Federal income tax purposes in 1960. The principal remaining State and local taxes, for which deductions may presently be taken, together with revenues derived from them by State and local governments in 1961, are as follows:

1. Gasoline taxes, $3.5 billion.
2. Auto and drivers' licenses, $1.8 billion.

3. Alcoholic beverage taxes, $0.7 billion.
4. Tobacco taxes, $1.1 billion.
5. Selective sales or excise taxes not included above (such as those on admissions, room occupancy, etc.), $1.8 billion.

(b) *General reasons for the provision.*—The House bill would provide for the continued deduction only of property taxes, income taxes, and general sales taxes. Your committee's amendments provide for the deduction of these three categories of taxes but also restores the deductibility of two categories of taxes which under the House bill would no longer be deductible. These are the excise tax on gasoline (and diesel and other motor fuels), and the taxes for auto registration and driver's licenses.

Your committee finds no disagreement with the House in the reasons given for the desirability of continuing the deductibility of property taxes, income taxes, and general sales taxes. In the case of property taxes, it was suggested that any denial of the deduction would result in an important shift in the distribution of Federal income taxes between homeowners and nonhomeowners. In the case of State and local income taxes, it was suggested that the continued deductibility of these taxes represent an important means of accommodation to take into account the fact that both State and local governments on one hand and the Federal Government on the other hand tap this same important revenue source. A failure to provide deductions in such a case could mean a combined burden of income taxes which in some cases would be extremely heavy. It was further indicated that, if property and income taxes are to be deductible for Federal income tax purposes, it also is important to allow the deduction of general sales taxes. To deny the deductibility of general sales taxes while allowing deductions for the other major revenue sources would encourage State and local governments to use these other resources in place of the sales tax. Your committee agrees with the House that it is important for the Federal Government to remain neutral as to the relative use made of these three forms of State and local taxation.

Your committee believes that much the same reasons which led to the House continuing the deduction of property, income, and sales taxes also suggest the desirability of continuing the deduction of gasoline and auto registration and drivers' licenses. Gasoline taxes are also a major source of State revenue and to deny the deduction of this tax while allowing the deduction of property, income, and general sales taxes tends to encourage States to use other than automotive taxes as their more important revenue sources. Moreover, a failure to provide a deduction for these automotive taxes also could result in an important shift in the distribution of Federal income taxes between classes of taxpayers, i.e., between those who own automobiles and those who do not.

Moreover, your committee is inclined to doubt that it is difficult for a taxpayer to make good estimates of the amount of these State and local automotive taxes as is sometimes suggested. The registration and drivers' license taxes are no more than annual taxes and certainly present the taxpayer with no particular recordkeeping problem. For most taxpayers the amount of gasoline taxes paid can be estimated relatively accurately either from credit sales slips or from the mileage added on a car each year.

Your committee agrees with the House that the other forms of excise taxes do present a recordkeeping problem for taxpayers. Also, it is recognized that these taxes, especially those on alcohol and tobacco products, may be deductible in some States and not in others, depending on the form of State law. As pointed out in the report of the House Committee on Ways and Means, in the case of cigarette and tobacco taxes, 26 States levy taxes which comply with the Federal rules for deductibility. However, 21 States and the District of Columbia have laws which do not meet these standards; and, thus, in these States, no deductions are available for these taxes.[1] There also is a wide variation among the States as to the deductibility of alcoholic beverage taxes. In six States, these taxes are imposed on the consumer and, therefore, are deductible. In addition, in 10 other States, where alcoholic beverages are sold through State liquor stores, the tax also generally is deductible.[2] This variation as to the Federal tax treatment of these various excise taxes is discriminatory as between taxpayers and different States. Moreover, it further complicates the already difficult problem of reporting deductible taxes in these cases. It should be noted, however, that this problem does not exist in the case of the gasoline, registration, and license taxes.

For the reasons indicated above, your committee is in agreement with the House as to the desirability of denying deductions in computing the Federal income tax for certain selective State and local taxes. However, in addition to retaining deductions for property, income and sales taxes, your committee has concluded that it also is desirable to retain deductions for gasoline and auto registration and driver's license taxes. Your committee has also made a modification with respect to limited types of improvement taxes which presently are deductible. As explained subsequently, under your committee's bill, such taxes to the extent now deductible will continue to be deductible.

(c) *General explanation of provision.*—For the reasons given above, your committee's bill provides as a general rule that only the following taxes may be taken as deductions:

1. State and local personal property taxes;
2. State and local, and foreign, real property taxes;
3. State and local, and foreign, income, war profits, and excess profits taxes; and
4. State and local general sales taxes;
5. State and local gasoline taxes (and taxes on diesel and other motor fuels);
6. State and local taxes on registering automobiles and on driver's licenses.

The fact that only these taxes may be deducted as taxes does not mean that other State, local, and foreign taxes may not be deducted to the extent they represent trade or business expenses or expenses incurred in the production of income. A sentence added to the code on this point makes it clear that these other State, local, and foreign taxes may be deducted as taxes when they are of a business nature or for the production of income even though otherwise they might have to be capitalized. Taxes levied on intangible personal property are examples of taxes generally deductible in this latter category since it

[1] Three States, Colorado, North Carolina, and Oregon, do not levy cigarette taxes.
[2] Seven States do not levy taxes on liquor except beer, and in some cases, wine. The beer and wine taxes of these States are not deductible.

can be reasonably supposed that the property subject to such a tax is held either in connection with a trade or business or for the current, or possible future, production of income.

(c)(i) *Taxes which in no event may be deducted.*—Under present law certain taxes, largely Federal taxes, may not be deducted in any case either as taxes or as business expenses or as expenses incurred in the production of income. To make clear the distinction between these taxes for which presently no deduction may be claimed and the other taxes which may be deducted if they represent expenses of a business or in the production of income, in the bill a new section (sec. 275) is added providing that no deduction at all may be taken for certain specified taxes. The taxes listed in this section are listed as exceptions in section 164 of the code under present law, and are moved to the new location in the code merely to emphasize the fact that these taxes cannot in any event be claimed as a deduction.

These taxes are as follows:

1. Federal income taxes;
2. Federal war profits and excess profits taxes; and
3. Estate, inheritance, legacy, succession, and gift taxes;
4. Income, war profits, and excess profits taxes imposed by a foreign country or a possession of the United States if the taxpayer chooses to take a foreign tax credit with respect to these taxes; and
5. Taxes on real property which the code requires to be treated as being imposed on another taxpayer.

Federal import duties and Federal excise and stamp taxes (to the extent not included in the above categories) will continue to be deductible to the extent they can presently be deducted as trade or business expenses (under sec. 162) or as expenses for the production of income (under sec. 212).

(c)(ii) *Definitions of certain deductible taxes.*—The bill defines a personal property tax which may be deducted as an ad valorem tax imposed on an annual basis in respect of personal property.

A general sales tax is defined as a tax imposed on one rate with respect to the sale at retail of a broad range of classes of items. The bill specifies, however, that the fact that food, clothing, medical supplies, and motor vehicles either are exempt from a sales tax or are taxed at a lower rate is not to result in any given tax being classified as not applying to a "broad range of classes of items." However, if any of these specified items are taxed at a higher rate than the general rate applying to other items, or if any other item is taxed at a different rate, no deduction is to be permitted for the tax on these items.

As under present law, deductions may be taken for general sales and gasoline taxes not only where they are imposed on the consumer as such, but also where they are separately stated and where the tax is in fact paid by the consumer.

Included in the definition of a deductible general sales tax by the bill is a "compensating use tax." A compensating use tax, as its name implies, is generally a tax imposed on items brought in from another taxing jurisdiction. In this case, the tax is imposed on the "use, storage, or consumption of the item" since the sale as such does not occur in the taxing jurisdiction in question. For such a tax to be deductible, similar items must be subject to a deductible general retail sales tax in the taxing jurisdiction in question.

(c)(iii) *Certain local improvement taxes.*—Under present law, local improvement taxes generally are not deductible (although interest or maintenance charges may otherwise be deductible). However, presently an exception is made and a deduction is permitted for local improvement taxes levied by a special taxing district where the district covers at least one entire county, at least 1,000 persons are subject to the tax levied by the district, and the district levies its assessment annually at a uniform rate on the same assessed value for real property as is used generally for purposes of the real property tax. The House would have eliminated this provision on the grounds that it is of limited application and also on the grounds that the continuation of this provision was not desirable. Your committee is in accord with the view that improvement taxes should not generally be deductible. However, in order to prevent the changing of rules of deductibility in this respect after debt has been incurred it has provided for the continued deduction of such taxes (to the extent presently deductible) for the purposes of paying off indebtedness already existing on December 31, 1963.

(c)(iv) *Effective date.*—The changes made by the above provisions relating to taxes apply to taxable years beginning after December 31, 1963.

(d) *Revenue effect.*—The changes made in the deduction of taxes by this section, as amended by your committee, are expected to increase revenues by $190 million in a full year of operation. The changes made by the House bill would have increased revenues by $520 million.

8. Personal casualty and theft losses (sec. 208 of the bill and sec. 165(c)(3) of the code)

(a) *Present law.*—Under present law, taxpayers may claim a deduction for losses of property not connected with a trade or business if these losses arise from fire, storm, shipwreck, or other casualty, or from theft. Under present law, these deductions are available without limitation to all taxpayers who itemize their personal deductions.

In addition, under present law, losses incurred in a taxpayer's trade or business or losses incurred in connection with transactions entered into for profit are deductible. The change made by this bill with respect to casualty losses described below does not affect the continued full deduction of these losses as business expenses or as expenses incurred in the production of income.

(b) *General reasons for provision.*—Your committee agrees with the House that in the case of nonbusiness casualty and theft losses, it is appropriate in computing taxable income to allow the deduction only of those losses which may be considered extraordinary, nonrecurring losses, and which go beyond the average or usual losses incurred by most taxpayers in day-to-day living. In view of this, it is believed appropriate to limit the casualty loss deduction to those losses or thefts above a minimum amount. The minimum selected was $100 per casualty loss, since this corresponds approximately with the "$100 deductible" insurance carried by many individuals in the United States with respect to such losses. This means that no deduction will be allowed in the case of an ordinary "fender bending" accident or casualty, but that casualty and theft losses will continue to be deductible (over the $100) in those cases where they are sufficient in size to have a significant effect upon an individual's ability to pay Federal income taxes.

(c) *General explanation of provision.*—The amendment made by both the House and your committee's versions of the bill limit the deductibility of personal losses (as distinct from those associated with a trade or business or transactions entered into for profit) to those where the casualty or theft loss exceeds $100. For this purpose, in determining what is a single casualty, it is intended that the law be interpreted liberally. Thus, for example, where an individual's property is damaged by wind from a hurricane and this is followed by additional damage resulting from water, it is intended that the combination of these events be treated as one casualty and, therefore, that all amounts over $100 of damage be deductible.

The $100 limitation applies to a joint return by a husband and wife as well as to a separate return of either. Thus, if a husband and wife file separate returns, each is subject to a separate $100 floor with respect to each casualty or theft, while, if they file a joint return, they are together subject to only one $100 floor with respect to each casualty or theft whether the loss is sustained with respect to jointly, or separately, owned property.

(c)(i) *Effective date.*—This amendment applies to losses sustained after December 31, 1963.

(d) *Revenue effect.*—It is estimated that this provision will increase revenues by $50 million a year in a full year of operation.

9. Charitable, etc., contributions, and gifts (sec. 209(a) of the bill and sec. 170(b) of the code)

(a) *Present law.*—Under present law, individuals are allowed a deduction of up to 20 percent of their adjusted gross income for contributions to or for the use of charitable, educational, religious, etc., organizations generally. An additional 10-percent deduction also is available for contributions to churches, schools, hospitals, certain medical research organizations, and certain organizations affiliated with State colleges or universities. Thus, with respect to contributions in this latter category, a charitable contribution deduction of up to 30 percent is allowed.

(b) *General reasons for provision.*—The House and your committee agree that the availability of this additional 10-percent deduction should be extended to include contributions to many forms of charitable or philanthropic organizations not now covered by this provision. Greater uniformity in the availability of this additional 10-percent deduction is desirable because of the many beneficial activities that are carried on by various philanthropic organizations not now eligible for the 30-percent deduction. This is especially true of many cultural and educational organizations and major charitable organizations not now eligible for the 30-percent deduction.

The additional 10-percent deduction is limited to organizations which are publicly or governmentally supported, however, and this additional deduction is not made available in the case of private foundations. These latter types of organizations frequently do not make contributions to the operating philanthropic organizations for extended periods of time and in the meanwhile use the funds for investments. The extra 10-percent deduction is intended to encourage immediately spendable receipts of contributions for charitable organizations.

(c) *General explanation of provision.*—For the reasons given above, the House and your committee's bill provide that the additional 10-

percent deduction (or 30-percent deduction in total) from a taxpayer's adjusted gross income is to be extended so that it not only is available with respect to charitable contributions to churches, schools, hospitals, etc., but also is available generally in the case of charitable contributions to religious, charitable, scientific, literary, or educational organizations or those for the prevention of cruelty to children or animals (which otherwise meet the conditions set forth in sec. 170(c)(2) of the code). In addition, the 30-percent deduction is to be available for charitable contributions to a Federal, State, or local governmental unit if the contribution or gift is made for exclusively public purposes.

For any of the nongovernmental organizations to qualify for the additional 10-percent deduction referred to above, they must normally receive a substantial part of their support from a governmental unit or from direct or indirect contributions from the general public. "Support" for this purpose does not take into account income received by the organization from exercise of its exempt function. The reference to direct or indirect contributions from the general public prevents what are generally termed private foundations from qualifying for this additional 10-percent deduction. To qualify, the organization must receive support from at least a representative number of persons within the community concerned.

Types of organizations which generally will in the future qualify for this additional 10-percent deduction are those publicly or governmentally supported museums of history, art, or science, libraries, community centers to promote the arts, organizations providing facilities for the support of an opera, symphony orchestra, ballet, or repertory drama, and organizations such as the American Red Cross, United Givers Fund, etc.

(*c*)(*i*) *Effective date.*—This provision applies to taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—This amendment is expected to result in a negligible revenue loss when fully effective.

10. Denial of unlimited charitable contributions deduction with respect to gifts to private foundations (sec. 209(b) of the bill and sec. 170(b)(1)(D) of the code)

(*a*) *Present law.*—Under present law, the 30-percent limitation with respect to charitable contributions deductions in the case of individuals does not apply if the taxpayer in the taxable year in question and in 8 out of 10 of the preceding taxable years made a charitable contribution which taken together with his income taxes with respect to each of those years equalled 90 percent or more of his taxable income for the year in question. Under present law, there is no distinction between charitable contributions in the 20-percent category and those in the 30-percent category for purposes of this unlimited deduction. Thus, the charitable contributions taken into account both in the taxable year and in the 8 prior qualifying years can be either those to public type charities or those to private foundations.

(*b*) *General reasons for provision.*—Your committee has added a provision to the bill making the unlimited charitable contribution deduction available only with respect to contributions to publicly supported organizations for much of the same reasons that both the House and your committee only make the extra 10-percent deduction

available in the case of these organizations. Your committee believes that the special advantage of the unlimited charitable contribution deduction should not be made available in the case of these private foundations because frequently contributions to foundations do not find their way into operating philanthropic endeavors for extended periods of time. In the meanwhile, the funds are invested and the advantages arising from control of these investments are likely to inure to the principal contributors to the foundations. Thus, your committee concluded that if the 20- or 30-percent limitations with respect to charitable giving are to be removed for those desiring to make large contributions there should be no question that the bulk of the funds involved, within a reasonable period of time, are devoted to the charitable and philanthropic purposes.

(c) *General explanation of provision.*—Your committee's amendment provides that for taxable years beginning after December 31, 1963, the charitable contributions taken into account with respect to the unlimited charitable contributions deduction are to be only those going to publicly supported organizations. Moreover, if the unlimited charitable contributions deduction is elected by the taxpayer, then he is to receive no charitable contribution deduction for amounts going to organizations which are not publicly supported, such as private foundations (even with respect to contributions coming under the 20-percent test, which, without this provision, would allow such contributions).

Similarly, in determining in a subsequent year whether contributions and taxes in 1964 and subsequent years meet the 90-percent test in 8 out of 10 years, contributions to private foundations are not to be taken into account. However, with respect to any year prior to 1964 in determining whether charitable contributions and taxes equal 90 percent or more of the taxpayer's taxable income for purposes of the 8- out of 10-year test, charitable contributions to private foundations may be taken into account in the same manner as under prior law. Thus, for purposes of the unlimited charitable contribution deduction, your committee's bill follows the rules of prior law whenever any year prior to 1964 is taken into account and the new rules applicable with respect to any computation involving 1964 or a subsequent year. As a result taxpayers will not find the rules changed with respect to past years' computations; but, if they hope to obtain the benefits of the unlimited charitable contribution deduction with respect to the future, then for subsequent years they will have to forego any income tax benefits for contributions or gifts to private foundations.

With respect to future years, the unlimited charitable contribution deduction will take into account charitable contributions to: churches; schools; hospitals; specified medical research organizations; certain organizations affiliated with State colleges or universities; Federal, State, or local governmental units, if the contribution or gift is made for exclusively public purposes; and charitable contributions generally to religious, charitable, scientific, literary, or educational organizations or those for the prevention of cruelty to children or animals. However, in this latter case, the charitable organization must receive a substantial part of its support from a governmental unit or from direct or indirect contributions from the general public. Support for this purpose does not take into account income received by the organization from the exercise of its exempt function. The reference

to direct or indirect contributions from the general public is designed to prevent gifts to private foundations from qualifying for this unlimited deduction. To qualify, the organization must receive support from at least a representative number of persons within the community concerned.

(c)(i) *Effective date.*—This provision applies to taxable years beginning after December 31, 1963.

(d) *Revenue effect.*—This amendment is expected to result in a negligible revenue increase.

11. Five-year charitable contributions carryover for individuals (sec. 209(c) of the bill and sec. 170(b)(5) of the code)

(a) *Present law.*—As indicated above, individuals are limited to a charitable contributions deduction of 20 percent of their adjusted gross income or up to 30 percent for contributions to churches, schools, hospitals, and contributions to public charities generally. Any charitable contributions in excess of the amount which may be deducted under these limitations in the current year in the case of individuals are wasted. Corporations, on the other hand, although limited to a charitable contributions deduction of 5 percent of taxable income (without this deduction) nevertheless may carry any unused charitable contribution deduction forward and under present law use them in the 2 following years. The House bill adds a provision which extends this carryover of unused charitable contributions for corporations to 5 years (see the discussion below).

(b) *General reasons for provision.*—Your committee has added a provision to the House bill to provide a 5-year carryover of unused charitable contributions for individuals. Your committee sees no reason why a carryover should be made available for corporations while individuals are in effect compelled to waste their contributions in excess of the specified limitation. More important, however, this will make it unnecessary for taxpayers desiring to make a contribution of a substantial nature to a charitable organization to carefully divide the gift into parts, contributing each in a separate year, or perhaps giving undivided interests in a property, up to their applicable limitation, to the charitable organization in each of a series of years. Not only is the present practice complicated for the donor but it also creates problems for the charitable or educational organization. Where they are given undivided interests in a property over an extended period of time, they may find it impossible either to sell or use the property over this same period of time while their interest in it gradually increases from year to year. The allowance of a 5-year charitable contribution carryover for individuals, like the averaging provision contained in this bill, also is another step toward the computation of income for tax purposes over a long period of time rather than on an annual basis.

(c) *General explanation of provision.*—For the reasons indicated above, your committee has added a provision to present law providing a 5-year carryforward for individuals for unused charitable contributions. In making this carryover available, your committee's amendments provide that the only amounts which may be carried forward are excess contributions with respect to which the 30-percent limitation applies (i.e., generally all contributions except those going to private foundations). In determining whether there is any unused charitable

contribution to carry forward, the charitable contributions to private foundations are ignored and only those contributions fully eligible under the 30-percent limitation, to the extent they exceed this limitation, may be carried forward.

In the year to which these contributions are carried, if the taxpayer has made any contributions to a private foundation, these are ignored for purposes of determining how much of these charitable contributions carried forward are used up in that year. This can be illustrated by the following example: Assume $500 of unused charitable contributions are carried forward, the individual's 30-percent limitation for the year in question would permit charitable contribution deductions of $1,000, and $400 had been already contributed in that year to private foundations and $300 to publicly supported charitable organizations. In this case the entire $500 carryforward would be considered as used up in that year, although the additional charitable contribution deductions obtained with respect to this $500 would be only $300. This result is obtained by ignoring the $400 of contributions to the private foundation for purposes of determining the extent to which the carryover is used up in that year. Thus, in the example cited, the charitable contribution in the year to publicly supported organizations was $300 and the carryover from the prior year was $500. This would make it possible to use up the entire charitable contribution carryover in that year. The individual could also deduct $200 of the $400 which he contributed to the private foundation. Since under existing law the individual in the example could have claimed a deduction of $700, the use of the carryover permits an additional deduction of $300.

The provision added by your committee also provides that no charitable contribution may be carried to, or through a year with respect to which the taxpayer has elected the unlimited charitable contributions deduction. The carryover was considered unnecessary in such cases because of the fact that no limitations are imposed in these cases. A technical adjustment is also made to prevent a taxpayer from claiming a benefit with respect to the same amount twice, through the interaction of the net operating loss carryover and the 5-year charitable contribution carryover.

(*c*)(*i*) *Effective date.*—The new 5-year charitable contributions carryover provided by your committee's bill will be available with respect to contributions paid in taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—This amendment is expected to result in a negligible revenue loss.

12. Five-year charitable contribution carryover for corporations (sec. 209(d) of the bill and sec. 170(b)(2) of the code)

(*a*) *Present law.*—Under present law corporations are allowed a maximum charitable contribution deduction of 5 percent of their taxable income computed without regard to this deduction (and certain other deductions). Any charitable contribution deductions which exceed this maximum may be carried forward and used in the 2 following years to the extent the maximum limitations for those years permit. In the case of tax-free reorganizations, generally, and in the case of the liquidation of a subsidiary, the present law provides that the 2-year charitable contribution carryover, to the extent not used by the prior corporation, is to be available to the acquiring corporation.

(*b*) *Reasons for provision.*—Situations have arisen where corporations have income which varies widely from year to year with the result that in some years they have losses and in other years income. This presents a problem where these corporations have committed themselves to the making of specific annual contributions to local charitable organizations. This frequently is done because of the importance to the local charity of maintaining a relatively stable budget from year to year. However, from the standpoint of the corporation the 5-percent limitation on charitable contributions means that the benefit of the charitable contribution deduction is lost in loss years, or in low income years, unless income is sufficiently high in the 2 immediately following years to not only permit the deduction of the amount carried forward but the usual charitable contributions for those years as well. Frequently this is not a sufficient length of time to enable the full deduction of charitable contributions in such cases.

(*c*) *General explanation of provision.*—In view of the above considerations the House bill substitutes for the 2-year carryforward of unused charitable contributions available in present law a 5-year charitable contribution carryforward for corporations. Your committee has accepted this amendment except that it has amended the effective date as indicated below. The amount which may be carried forward in such cases is the amount of the charitable contributions in excess of the amount which may be deducted within the 5-percent limitation. In the year to which the charitable contributions are carried the charitable contributions of that year are applied first, and then the charitable contributions carried forward with the oldest year from which a charitable contribution is carried forward being applied first. Any unused charitable contributions are carried forward to succeeding years, but if not used up after a 5-year carryforward period, they no longer are available for further deduction.

The 5-year charitable contribution deduction carryover is also made available to acquiring corporations in tax-free reorganizations and to parent corporations in the case of the liquidation of a subsidiary. The acquiring corporation in these cases treats the carryforward of the charitable contribution in the same manner as if it were its own unused charitable contribution being carried forward to the current year.

(*c*)(*i*) *Effective date.*—The 5-year carryforward under the House bill would be effective with respect to contributions paid (or treated as paid) in taxable years beginning after December 31, 1963. Thus, under the House bill a charitable contribution made in 1964 would be the first charitable contribution with respect to which the 5-year, as distinct from the 2-year, charitable contribution carryforward would be available. Under your committee's amendments, the 5-year carryforward of unused charitable contributions will be available with respect to contributions paid (or treated as paid) in taxable years beginning after December 31, 1961. Thus, charitable contributions made in the calendar years 1962 and 1963, (to the extent the former is not used in 1963) will be available as carryforwards to 1964, since in these cases the 2-year carryforward from these years has not yet expired.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible loss of revenue when fully effective.

13. Limitation on charitable contribution deduction for future gifts of tangible property (sec. 209(e) of the bill and sec. 170(f) of the code)

(*a*) *Present law.*—Under present law, if a taxpayer gives property to charity but retains for either his or someone else's life or any other period the use or enjoyment of the property, he receives a charitable contribution deduction for income tax purposes at the time of the gift of the future interest in an amount equal to the present discounted value of that future interest.

(*b*) *General reasons for provision.*—The House report calls attention to the problem where pictures or art objects are given to museums, but the gift takes effect at some future time, usually based upon the life of the contributor or someone else. In the meanwhile, the use of the pictures or art objects is retained in much the same manner as if the contribution of the future interest had not been made. The same enjoyment would occur, for example, if instead of making a gift of a future interest, the taxpayer were to wait until his, or his family's use of the property was completed. If this use was completed at the time of his death, however, no charitable contribution for income tax purposes could be claimed, even though an estate tax deduction would be available.

The report of the House Committee on Ways and Means suggests generally that it is inappropriate for taxpayers using this device to obtain what amounts to an extra charitable contribution deduction for income tax purposes. However, the House report further suggests that in the ordinary case where the contributor retains the right to use the property for his own life that this in fact has been a strong inducement for giving pictures and art objects to museums and other cultural centers in the United States and that in any event much of the problem which has arisen in the past has stemmed from the problem of valuing the pictures and art objects given.

Based upon the consideration outlined above, the House bill provided a general rule which denied deductions for charitable contributions in the form of future interests in tangible personal property, but then made this rule inapplicable where the life interest was retained for the life or lives of the contributor or contributors. Your committee is in agreement with the general rule adopted by the House but believes that the exception making this general rule inapplicable in the case where a life estate was retained by the contributors in effect makes this rule inapplicable to the bulk of the cases which should come under the rule. Your committee sees no more reason for granting a charitable contribution deduction for income tax purposes whether the life interest is reserved for the contributor or someone else. It recognizes that for some taxpayers this may have some temporary effect in dulling the special incentive now existing for giving pictures and art objects to museums and other cultural centers. Moreover, some taxpayers may be induced under this provision to give their pictures or other objects outright during life rather than wait until their death, thereby accelerating gifts to museums and other organizations. In any event, your committee questions whether it is appropriate to provide the special stimulus of an income tax deduction, in addition to a charitable deduction for estate tax purposes, to induce this result.

(*c*) *General explanation of provision.*—For the reasons indicated above your committee's amendments provide that charitable con-

tributions in the form of a future interest in tangible personal property are to be treated as deductible for income tax purposes only when all interests in, and rights to possession or enjoyment of, the property in question has been given up. Your committee has deleted the exception in the House bill making this rule inapplicable in the case of charitable contributions where the only reservation in the gift is that the property is not to be transferred until the death of the contributor or contributors.

Any type of a reservation by the contributor and any reservation in the hands of related persons described in section 267(b) of the code under your committee's action will result in a denial of the charitable contribution deduction as long as the reservations continue.

Although generally this provision is limited to gifts of future interests in tangible personal property the provision also covers fixtures which are intended to be severed from the real property, such as chandeliers, mantels, etc.

(*c*)(*i*) *Effective date.*—This provision applies to transfers after December 31, 1963.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible revenue gain when fully effective.

14. Losses arising from expropriation of property by governments of foreign countries (sec. 210 of the bill and sec. 172(b)(1)(D) of the code)

(*a*) *Present law.*—Generally, under present law, a net operating loss may be carried back to each of the 3 prior years and then, to the extent of any loss still not offset against income, the balance may be carried forward to the 5 succeeding years—providing a period of 8 years over which a loss may be spread. In two cases under present law, however, longer loss carryover periods are provided. Thus, in the case of corporation suffering losses which are certified as arising with respect to the "Trade Expansion Act of 1962", a 10-year carryover period is provided—a 5-year carryback and a 5-year carryforward. Present law also provides a 10-year carryover period in the case of regulated transportation companies—in this case a 3-year carryback and a 7-year carryforward.

(*b*) *General reasons for provision.*—Your committee has been informed that since World War II at least 14 foreign governments have expropriated property of U.S. taxpayers. The most significant of these expropriations was that made in Cuba, beginning in 1959 when all U.S. investments in that country were expropriated by the government.

Generally, it is believed that the 3-year carryback and 5-year carryforward for net operating losses provide a sufficient period for the recovering of substantially all business losses. In those cases, however, where this period has proved insufficient, Congress has followed the policy of providing a longer loss-carryover period. This accounts for the 10-year period in present law for those suffering losses arising under the Trade Expansion Act of 1962 and for the 10-year period in the case of regulated transportation companies.

Your committee believes that the expropriations by foreign governments which have occurred in recent years represent another example of larger than usual losses, where the usual 8-year carryover period for losses is inadequate. Therefore, your committee's amendments

extend the 10-year loss period, already applied in special cases, to expropriation losses. A 10-year carryforward with no carryback is provided for these expropriation losses. The longer carryforward has been substituted for the 3-year carryback because, if carrybacks were required, the taxpayers might have to forego the benefits derived from using foreign taxes as credits rather than deductions with respect to the back years.

(c) *General explanation of provision.*—Your committee's amendment provides a 10-year carryforward with no carryback for expropriation losses. This is available with respect to expropriation losses arising in taxable years ending after December 31, 1958. Thus, it will include 1959 which was the year the Cuban expropriations began.

To qualify for the 10-year carryforward, the expropriation loss must be at least 50 percent of the total net operating loss for a year. Thus, this extra carryforward period will not be available unless the expropriation loss is a major proportion of a company's net operating loss.

To receive this treatment, the taxpayer must elect the 10-year carryforward on or before the time specified by regulations prescribed by the Secretary of the Treasury or his delegate. However, in the case of past years with respect to which the 10-year carryforward is to be available, namely the years 1959 through 1963, taxpayers are to have until December 31, 1965, to make the elections for these years. In these cases the statute of limitations will be opened for deficiencies or refunds with respect to any years affected by the change and ending before 1964. Taxpayers are also to have an opportunity to make a new election with respect to the foreign taxes for this back period—to take either a deduction or a tax credit as the changed circumstances arising from the longer carryforward of losses (and no carryback of these expropriation losses) warrant.

The types of losses involved are trade or business, or production of income, losses which are "sustained by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or agency or instrumentality of the foregoing * * *." Such a loss is to be considered a "foreign expropriation loss."

A foreign expropriation loss will be treated separately from any remaining net operating loss for the same year. The regular net operating loss for the year will be carried back and used up to the extent of the income in the 3 prior years. Then, if any of the regular net operating loss still remains, it will be carried forward to the next year and used first. Only after the net operating loss is fully applied in the first carryforward year will any expropriation loss from the same year be used in that year. Thus, the expropriation loss will be considered the last portion of the total net operating loss applied in any case, although the expropriation loss for a year will be applied before the regular net operating loss for any succeeding year.

(c)(i) *Effective date.*—This provision applies with respect to foreign expropriation losses arising in taxable years ending after December 31, 1958.

(d) *Revenue effect.*—This provision is expected to result in a revenue loss of approximately $5 million a year in 1965, but it expected to decline appreciably after 1970.

15. One percent limitation on medicines and drugs for those over age 65 (sec. 211 of the bill and sec. 213 of the code)

(*a*) *Present law.*—Under present law, generally only what are considered abnormal medical expenses are deductible. This result is attained by limiting expenses which may be deducted to the excess of these expenses over 3 percent of the individual's adjusted gross income (income after business and similar expenses but before personal exemptions and personal expenses). In computing medical expenses subject to this 3-percent limit, medicines and drugs may be taken into account only if they exceed 1 percent of adjusted gross income. The 3-percent limitation does not apply in the case of the taxpayer and his spouse where either of them is 65 or over nor does it apply in the case of medical expenses of the mother or father of the taxpayer or of his wife where the parent is 65 or over and receives his principal support from the taxpayer. The 1-percent limitation on medicines and drugs, however, applies to everyone without regard to their age.

(*b*) *General reasons for provision.*—The House bill repeals the 1-percent limitation with respect to medicines and drugs insofar as it relates to a taxpayer, or his spouse either of whom is age 65 or over, or to the parent of the taxpayer (or his spouse) where the parent is a dependent of the taxpayer and is 65 or over. The effect of this is to provide that the 1-percent limitation will apply only in those cases where the 3-percent limitation also applies. Your committee is in accord with this action, because it, like the House, believes that it is undesirable to impose any minimum limitation with respect to the deductibility of medical expenses in the case of the aged. It also believes that conforming the application of the 1-percent limitation with the 3-percent limit will simplify the statute somewhat in this area.

(*c*) *General explanation of provision.*—Present law provides that medicines and drugs which otherwise would be taken into account in computing medical expenses (which are either deductible in whole, or to the extent they exceed 3 percent) are to be deductible only to the extent that the total of these medicine and drug expenses exceed 1 percent of the taxpayer's adjusted gross income. Both the House and your committee's version of the bill make this 1-percent limitation inapplicable in the case of amounts paid for the care of the taxpayer and his spouse if either of them has attained age 65 before the end of the taxable year. Both versions also provide that this 1-percent limitation is not to apply to amounts paid for the care of a dependent mother or father of the taxpayer or his spouse if the mother or father has attained age 65 before the end of the year and also is a dependent of the taxpayer. Thus neither the 3-percent limit on medical expenses generally nor the 1-percent limit on medicines and drugs will apply to the categories of persons specified above who are age 65 or over. The maximum limitations on medical expenses, however, continue to apply to these and other persons in the same manner as under existing law.

(*c*)(*i*) *Effective date.*—This provision is to apply to taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—This provision is expected to result in a revenue loss of $10 million in a full year of operation.

16. Care of dependents (sec. 212 of the bill and sec. 214 of the code)

(*a*) *Present law.*—Under present law, a deduction of up to $600 is allowed in certain cases for expenses of child care incurred to enable a taxpayer to be gainfully employed. At present, this is available for single women, women who are divorced or separated, or in some cases, deserted, and widows and widowers, having one or more dependents without regard to the amount of the taxpayer's earnings. In the case of working wives, the $600 deduction is presently available only if the combined adjusted gross income of the wife and husband (who must file a joint return) does not exceed $4,500. If their income exceeds this amount, the deduction available is decreased $1 for each dollar of income above $4,500, thus disappearing entirely at an income level of $5,100. An exception to this rule provides that this income limitation is not to apply if the husband is incapable of self-support because mentally or physically defective.

A dependent of the taxpayer for whom this $600 may be claimed must be a son or daughter (or stepson or stepdaughter) of the taxpayer who is under age 12 or a dependent who is physically or mentally incapable of caring for himself.

(*b*) *General reasons for provision.*—Your committee, while agreeing with the changes made by the House bill in the child-care provision, found them too narrow. As a result, it has liberalized the changes made by the House bill to also include the principal changes recommended by the administration with respect to this provision which were omitted in the House bill. These changes have also been recommended by the President's Commission on the Status of Women. The most important change made by your committee in the House provision is to raise from $4,500 to $7,000 the income limitation applicable with respect to working wives. In 1954, when provision was first made for the deduction of child-care expenses with respect to working wives, your committee in its report then stated:

> * * * [I]t is recognized that in many low-income families, the earnings of the mother are essential for the maintenance of minimum living standards even where the father is also employed, and that in such situations, the requirement for providing child care may be just as pressing as in the case of a widowed or divorced mother.

Thus, Congress provided for the deduction of child-care expenses in the case of working wives because it was recognized that the maintenance of a minimum standard of living in these cases required the wife to work. However, the present maximum joint income level of $4,500 is so low that relatively few working wives presently can claim this deduction. Of the 244,000 taxable returns claiming the deduction in 1960, only 117,000 were joint returns filed by married couples. In 1961, according to Department of Labor statistics, the median income of husband-wife families in which the wife worked at any time during the year was $7,050. Thus, the $4,500 limitation falls far short of covering the average case where the wife has found it necessary to supplement the husband's income by working. To carry out the original intention of Congress with respect to this provision, your committee's bill raises the joint income limitation for husbands and wives who may claim the child-care expense deduction from $4,500 to $7,000.

Under present law, the maximum amount which may be deducted for child care is $600 per year per taxpayer. As the House report indicates a flat limitation of this type fails to take into account the fact that the costs of caring for dependents, particularly where they must be cared for outside of the home, increases as the number of dependents increases. Because of this, the House bill raised the maximum deduction which may be claimed for child-care expenses to $900 where the taxpayer has two or more dependents. Your committee's bill carries this one step further and provides a maximum deduction of $1,000 where there are three or more qualifying dependents. It also makes this graduated maximum available in the case of working wives as well as where there is only one parent. These expenses are as likely to increase on a per-child basis in the case of a married couple as in those cases where there is only one parent.

In other respects, your committee's amendments, with minor technical exceptions, follow the House bill. Thus, as under the House bill, relief is provided where the wife is either in an institution or is physically or mentally incapable of caring for herself. Under present law, if the husband is incapable of self-support because of mental or physical deficiencies, the wife is fully eligible for the deduction without regard to the family income level. Your committee agrees with the House that a family where the wife is in an institution is at least as likely to incur expenses for child care as a family where the husband is incapable of self-support. Similarly, it also agrees that child-care expenses are likely to be required, where the wife is in the home but not capable of caring for herself. As under the House bill, your committee's amendments extend present law to permit child-care expenses in these cases, subject to limitations, to be deducted. Your committee in this regard modified the House provision only in that in the case of incapacitated wives, the deduction is to be fully available where the adjusted gross income of the taxpayer and his spouse does not exceed $7,000 rather than $4,500. This is in conformity with its change in the income level generally applicable in the case of working wives.

Both the House and your committee's bill also raise the maximum age limit generally available from 12 to 13 years for children with respect to whom the child-care deduction generally may be taken.

(c) General explanation: Raising income limitation from $4,500 to $7,000.—Your committee's amendments, as distinct from the House bill, increase from $4,500 to $7,000 the amount of income that families with working wives can earn and still qualify for the full amount of the deduction for expenses incurred for the care of children or dependents. The House bill made no change in this area. This raising of the income limitation to $7,000 is in accordance with the recommendation of the administration.

Under present law, for every dollar of income a husband and working wife have above $4,500, the maximum limit on their deduction for child-care expenses is reduced by a similar dollar below the $600 level. Thus, under present law with the $600 limitation, it is possible for a husband and working wife to receive some child-care expense deduction in the case of those with incomes up to $5,100. Under your committee's bill, since the maximum child-care expense deduction (where there are three or more children) is raised to $1,000, it will be possible for husbands and wives who are both working to claim some

child-care expense deductions in cases where their joint incomes are up to $8,000. In 1960, the child-care expense deduction was claimed on 244,000 taxable returns. It is anticipated that the liberalizing amendments, primarily raising the income level for working wives to $7,000, will make this deduction available to an additional 200,000 returns or 444,000 taxable returns in all.

(c)(i) *General explanation: Raising the deduction to $900 or $1,000 in certain cases.*—Under present law, as previously indicated, the maximum annual deduction which may be claimed by a taxpayer is $600. The House bill, where there are two or more qualified dependents, would raise this maximun deduction which may be taken, for expenses incurred by the taxpayer, to $900. Your committee's amendments provide that the $600 limitation, as under the House bill, is still to be applicable where the taxpayer has only one dependent and that the $900 limitation is to be applicable where the taxpayer has two dependents. However, it provides that where there are three or more qualifying dependents, the maximum deduction which may be taken is to be $1,000, in lieu of the $900 provided by the House bill. The $900 and $1,000 limitations are also to be available in the case of working wives who are eligible for the child-care deduction (under the House bill, the $600 limitation would continue to apply in such cases).

(c)(ii) *General explanation: Incapacitated and institutionalized wives.*—The House bill adds to the list of situations where the child-care deduction may be claimed those cases where a wife is incapacitated or institutionalized. Your committee's amendments accord substantially the same treatment. For the husband to be eligible for this deduction, the wife must be institutionalized or incapacitated for 90 consecutive days (or a shorter period if she dies). In the case of incapacitated wives, under the House bill the deduction would be fully available only where the adjusted gross income of the taxpayer and his spouse does not exceed $4,500 (for incomes above that level, the deduction would decrease $1 for each dollar of income above $4,500). Under your committee's amendments, the $4,500 limitation in this case is replaced by the $7,000 limitation. The income limitation under both the House bill and your committee's amendments does not apply if the taxpayer's wife is institutionalized for a period of 90 days or more. A wife is considered as being incapacitated if she is incapable of caring for herself because she is mentally or physically defective (including any time she is institutionalized). A wife is considered institutionalized while she is receiving medical care or treatment as an inpatient, resident, or inmate of a public or private hospital, sanitarium, or similar institution.

(c)(iv) *General explanation: Raising the age limit for children to 13.*—Present law provides that a dependent, for purposes of the child-care deduction (if not physically or mentally incapable of caring for himself), must be a son or daughter (or stepson or stepdaughter) of the taxpayer and must not have attained the age of 12. The House bill raises this age limit to 13 and your committee's amendments make no change in the House bill in this respect.

(c)(v) *Effective date.*—The amendment made by this provision apply to taxable years beginning after December 31, 1963.

(d) *Revenue effect.*—Changes made by the House bill with respect to the child-care provision in a full year of operation would have resulted in a revenue loss of $5 million. The changes made by your

committee increase this loss by $15 million or to a total of $20 million when compared with present law.

17. Moving expenses (sec. 213 of the bill and sec. 217 of the code)

(*a*) *Present law.*—Under present law, certain moving expenses of existing employees if reimbursed by the employer are held to be excludable from the employee's income. They have been ruled excludable on the ground that they are incurred "in the interest of the employer" (Rev. Rul. 54-429, C.B. 1954-2, 53).

Under present law, the moving expenses (for moving from one official station to another for permanent duty) which the Internal Revenue Service has agreed are excludable for existing employees where they are reimbursed are:

1. Transportation expenses for moving the employee and his family;
2. Transportation and certain related costs of moving the personal and household effects of the employee and his family; and
3. Expenses incurred for meals and lodging for the employee and his family while they are en route to their new location.

In addition, in two court cases, taxpayers have been permitted to exclude other types of moving expenses, although the Internal Revenue Service has not acquiesced in the exclusion of these other types of moving expenses.[1]

On the other hand, reimbursements for moving expenses received by new employees from their employers are includible in gross income. Moreover, no deduction is allowed for moving expenses of any employee with respect to expenses for which no reimbursement is received.

(*b*) *General reasons for provisions.*—Your committee agrees with the House that the existing tax treatment of moving expenses needs modification because the present treatment discriminates against both new employees and employees who are not reimbursed for their moving expenses by their employers. There is no reason why new employees should include in their income amounts representing moving expenses which, if received by an existing employee who is moved by his employer from one location to another, would be excludable from income. Neither is there any reason for discriminating against those employees who are not reimbursed for their moving expenses, but who incur such expenses in seeking job opportunities. Moreover, it is important to remove deterrents to the mobility of labor. Any thing which can be done in this respect should aid in reducing local structural unemployment.

Both the House and your committee's bill limit the categories of expense for which a deduction is available to new employees or those who are not reimbursed for moving expenses to the three categories specified above, which, by ruling, the Internal Revenue Service recognizes the reimbursements of which are as excludable for existing employees. No inference should be drawn from this, however, that moving expense exclusions under existing law are necessarily limited

[1] In *John E. Cavanagh* (36 T.C. 300; 1961) it was held that living costs incurred by the employee in excess of ordinary living expenses of his family were excludable where they were reimbursed while his household effects were in transit. In *Otto Sorg Schairer* (9 T.C. 549; 1947) it was held that where an employee was reimbursed for a loss incurred in selling his home this reimbursement was an addition to the sales price. More recently, however, the Tax Court held that reimbursements of similar expenses were additional compensation and not excludable from the employee's income in the case of *Harris W. Bradley* (39 T. C. 652; 1963 aff'd, 324 F. 2d 610 (4th Cir. 1963). A reimbursement on sale of a house was also held to be compensation in *Arthur V. Kobacker* (37 T.C. 882; 1962).

to these three categories of expenses. However, since by administrative ruling, these categories are clearly excludable in the case of existing employees who are reimbursed, it is believed that deductions for such expenses should also be made available to new employees and nonreimbursed employees as well. The question of whether the exclusion for existing employees extends beyond these three categories is left for judicial interpretation.

(c) *General explanation of provisions.*—The deductions allowed by the House and your committee's bill with respect to moving expenses are to be deductible in computing "adjusted gross income." These expenses, therefore, are deductible whether the individual involved itemizes his personal deductions or takes the standard deduction. This treatment is provided not only because these expenses are substantially similar to business expenses, but also because when they are incurred, they are likely to be relatively large. In such cases, it was thought that it would be undesirable to, in effect, make taxpayers choose between taking this deduction and the standard deduction in lieu of itemized personal deductions.

No deduction is provided under this provision for moving expenses for which the taxpayer receives reimbursements which are not included in his gross income. Thus, existing employees may continue to exclude reimbursed moving expenses from their gross income in the same manner as under present law. Their status, in this regard, is left entirely unchanged.

The types of moving expenses which may be deducted under this provision are reasonable expenses for—

1. Moving household goods and personal effects from the former residence to the new residence;
2. Transportation expenses of the employee and his family from the former residence to the new place of residence; and
3. Expenses for meals and lodging while in transit from the former residence to the new place of residence.

The moving expenses referred to are available not only with respect to the taxpayer, but also to any other members of the taxpayer's household who had as their permanent place of abode the taxpayer's former residence and moved to his new residence. (For amendment added by your committee with respect to sales of residences of employees who are moved see sec. 232 of the bill, item 39 below.)

(c)(i) *Limitations.*—To prevent the deduction of moving expenses for short moves, the bill provides that, for a deduction to be available, the taxpayer's new place of work must be at least 20 miles farther from his former residence than was his former place of work. In other words, his commuting distance must have increased by at least 20 miles to be eligible for this deduction. If the individual involved previously had no place of work, his new work location must be at least 20 miles from his former residence.

To prevent individuals from taking temporary jobs in order to obtain the deduction of moving expenses, it is provided that during the 12-month period immediately after the individual's arrival at his new principal place of work, he must be a full-time employee in that general location for three-fourths of the time (39 weeks). This limitation, however, is not applied to the extent where the individual is reimbursed for his moving expenses by his employer since, presumably, an employer would not reimburse such expenses even for a new

employee unless it was his intention that the individual remain employed for an extended period of time.

This requirement that an employee be a full-time employee in a general location for three-quarters of a year after moving means that where he has moved after the first half of the year, he cannot be sure when he files his return in the following April that he will meet this 9 months' requirement. For that reason, the employee in such a case is permitted to claim the moving expense deduction (assuming he has not already disqualified himself by that time, such as by moving out of the general location). Then, if after filing his return he fails to qualify for the moving expense deduction by not remaining employed full time for 39 weeks in the new location he is to include in his gross income for the following year the amount of moving expense deduction claimed in the prior year.

(*c*)(*ii*) *Effective date.*—The new treatment provided by this provision applies to expenses incurred after December 31, 1963.

(*d*) *Revenue effect.*—It is anticipated that this provision in a full year of operation will result in an annual revenue loss of $60 million a year.

18. Deduction for political contributions (sec. 214 of the bill and sec. 218 of the code)

(*a*) *Present law.*—Up to the present no deduction or credit has been allowed for political contributions of any type. In fact, charitable and educational contributions presently may be denied if the organizations involved spends any substantial part of its activities in attempting to influence legislation.

(*b*) *General reasons for provisions.*—Your committee's bill departs with the precedent in this respect primarily because of the report of the late President Kennedy's Commission on Campaign Costs and because of his recommendation to Congress with respect to this report. This section, while not identical to the proposal of the late President, nevertheless is substantially similar to it, and in your committee's opinion carries out the objectives of that request. The purpose of allowing a limited deduction for campaign contributions is, as indicated by the late President, to broaden the base of contributions: "to reduce dependence on large contributions of those with special interests." As he indicated, this section "is designed to give party solicitors an additional tool to help stimulate individuals to contribute money, in * * * election years."

(*c*) *General explanation of provision.*—The new section added by the bill allows a deduction for political contributions up to a maximum of $50 a year in the case of a single person (or a married person filing a separate return) and up to $100 a year in the case of a married couple filing a joint return. The amounts for which deductions are permitted are limited in order to achieve the objective of the late President Kennedy in "broadening the base of political contributions."

These deductions are available only to those who itemize their deductions, rather than taking a standard deduction. Therefore, this places these limited deductions for political contributions in the same category as charitable contributions, deductible taxes, interest, certain medical expenses, etc.

The bill provides that this deduction for political contributions is to be allowed only if the fact of the political contribution is verified in such manner as the Secretary of the Treasury or his delegate prescribe

by regulation. It is anticipated that under this grant of authority the Secretary of the Treasury will provide that the deduction will be available only where the taxpayer, if his return is audited, presents adequate records to show that he has actually made the political contributions to a qualified candidate or committee. This will give assurance against the claiming of deductions for fictitious political contributions.

A political contribution which as a result of the new section added by the bill will be deductible must be a contribution or gift to a "political candidate" or "political committee." However, in addition, it is required that the contribution be made only for the purpose of furthering the candidacy of one or more individuals in a general, special, or primary election or a convention of a political party. Thus, contributions or gifts to further the cause of a referendum or other issue on a ballot will not be deductible. The candidate with respect to which the deduction of a contribution or gift may be claimed may be a candidate for National, State, or local office and may be either a partisan or nonpartisan candidate. Thus, for example, where judges are elected officials, contributions for their candidacy may be deducted. The candidacy of the individual may be either for a primary election or for a convention of a political party nominating candidates for office or for a general election. Included also are special elections to fill vacancies.

The deduction for political contributions under the bill is limited to contributions made by individuals. It is not available with respect to contributions from corporations or from estates or trusts.

(*c*)(*i*) *Effective date.*—The bill provides that contributions or gifts made after the date of enactment of this bill are to be deductible.

(*d*) *Revenue effect.*—It is anticipated that this provision will result in a revenue loss of approximately $25 million a year for Presidential election years; 50 percent of that amount for congressional election years; 25 percent for off years; and average about $15 million per year.

19. One hundred-percent dividends received deduction for members of electing affiliated groups (sec. 215 of the bill and sec. 243 of the code)

(*a*) *Present law.*—Present law in general provides a deduction equal to 85 percent of the dividends received by one corporation from another domestic corporation. This has the effect of taxing 15 percent of intercorporate dividends received. With the present 52-percent tax rate, this is a tax of 7.8 percent on the entire dividend (15 percent times 52 percent), or in the case of the 48-percent rate effective under this bill for corporations in 1965 and subsequent years, a tax on the entire dividend of 7.2 percent.

(*b*) *General reasons for provision.*—The administration in its initial recommendation to Congress proposed that the 2-percent penalty tax on consolidated returns be repealed that controlled groups be limited to a single surtax exemption, and also, that the intercorporate dividends received deduction be increased to 100 percent in the case of amounts received as a dividend from a corporation which is a member of the same parent-subsidiary affiliated group. In this regard, the Secretary of the Treasury in his explanation of this provision to the Ways and Means Committee stated:

> The elimination of the intercorporate dividend tax in this type of parent-subsidiary relationship would extend to such

groups one of the tax advantages generally now available only to affiliated groups which file consolidated returns. This amendment is designed to facilitate the adjustment to the elimination of multiple surtax exemptions in cases where the affiliated group does not, or cannot, file consolidated returns, but would recognize that the earnings of an 80-percent-owned operating subsidiary are more directly the earnings of the parent than is the case where one corporation merely derives investment income from an unrelated corporation.

Your committee is in accord with this recommendation of the administration. Your committee concluded that it would be inequitable to repeal the consolidated return 2-percent tax without also providing a 100-percent intercorporate dividends received deduction for corporations meeting the same tests of common ownership, but which for one reason or another cannot, or do not want to, file a consolidated return and are willing to forgo multiple surtax exemptions. Among the principal reasons for not being eligible to file a consolidated return in the case of an affiliated group is the need for different members of a group to maintain different fiscal years due to variations in the natural business years of the different companies involved. Still another factor accounting for some corporations in an affiliated group not filing consolidated returns is the necessity to use the same accounting method (unless the Internal Revenue Service specifically permits a variance) although there may be valid business reasons for the different accounting methods in the case of the different businesses. Another reason which applies in the case of life insurance companies is that under present law such companies may not file a consolidated return with other domestic corporations which are not life insurance companies. Moreover, still other corporations are hesitant to file consolidated returns because of the sheer complexity of the consolidated return regulations.

For these reasons, your committee has added a provision granting a 100-percent dividends-received deduction in those cases where corporations are affiliated but they do not file a consolidated return. To be sure that no special advantage was given these corporations over those corporations which do file consolidated returns, your committee has reviewed the various provisions of the code and denied tax benefits in those cases where the separate corporations received significant advantages over a consolidated group. Thus, where this 100-percent dividends-received deduction is elected, the group is to have only one $25,000 surtax exemption for the group, the election with respect to foreign tax credits or deductions must be the same for all members of the group, only one $100,000 minimum accumulated earnings credit is to be allowed in determining exemptions from the tax on unreasonable accumulations, only one $100,000 exemption in computing estimated tax subject to accelerated payments is to be allowed, and limitations generally applicable to a single corporation are provided in the case of exploration expenditures.

(c) *General explanation of provision.*—A 100-percent dividends-received deduction is allowed by your committee's amendment when dividends are paid by a domestic corporation but only where the dividends are "qualifying dividends." To be qualifying dividends

they must be received from a corporation which is a member of the same affiliated group of corporations. "Affiliated group" for this purpose is defined in the same manner as an affiliated group for purposes of the requirement for filing a consolidated return except that a domestic insurance company (taxable under section 802 or 821) is treated as an includible corporation. For the dividends to be qualifying, the receiving and distributing corporation must be members of the same affiliated group at the time of the distribution and also the dividends must be distributed out of earnings and profits of a year ending after December 31, 1963, when on each day of which the two corporations were members of the same affiliated group and were not claiming multiple surtax exemptions.

The determination as to what earnings and profits a dividend is considered as being distributed out of will be made under the rules applicable elsewhere in the code for this purpose; i.e., they will be considered as paid first out of the current year's earnings and profits and then, to the extent of any excess, out of the prior year's earnings and profits, then, to the extent of any excess, out of the second prior year's earnings and profits, etc. In addition, the dividends must be paid at a time when the distributing and receiving corporations are members of an affiliated group which has elected to qualify for the 100-percent dividend-received treatment provided by the new section.

An election must be made by the parent corporation and consented to by each of the subsidiary corporations. The election is effective for the taxable year of the subsidiaries which includes the last day of the year of the parent with respect to which the election was initially made. In addition, the election applies automatically for each succeeding year unless the election is specifically terminated. A special rule provides that with respect to fiscal years beginning in 1963 and ending in 1964, the election would be effective as long as the last day of the corporation's year is included in a year of the parent for which an election is effective.

An election may be terminated by an affiliated group if the affiliated group files a termination of the election and each member of the group consents to this termination. In addition, the election may be terminated where a new member is added to the affiliated group and this member files a statement to the effect that it does not consent to the election.

Where an affiliated group elects the 100-percent dividend paid treatment, the members of the group must forego certain advantages which they otherwise would have as separate corporations. These rights are withdrawn since they are not available to a group filing a consolidated return, where the tax advantages are substantially similar to those provided in the case of the 100-percent dividends received deduction. The advantages of separate treatment which the affiliated group must forego if this election is made are as follows:

1. The group may not elect to receive more than one surtax exemption.

2. All members of the group must all make the same elections with respect to foreign taxes; i.e., they must all elect either to claim deductions for these foreign taxes or foreign tax credit; and, if they claim foreign tax credit, they must all either elect the "per country limitation" or the "overall limitation" in computing the size of the credits available. They will each, however, continue to compute their own

foreign tax deduction or credit in the same manner as separate corporations.

3. In determining whether or not the various corporations in the affiliated group are subject to the accumulated earnings tax (imposed by section 531), only one $100,000 minimum accumulated earnings credit would be available for the entire group.

4. In determining the tax liability of the group which will be subject to estimated tax (i.e., acceleration of corporate payments so that the tax is paid in the year of liability rather than in the succeeding year), only one exemption of $100,000 of tax liability is to be available to the entire group rather than to each member of the group.

5. In determining the maximum amount of exploration expenditures with respect to mineral deposits which may be written off in any one year or treated as a deferred expense the group of affiliated corporations making this election is to be eligible to write off one $100,000 in any one year with a total of $400,000 over any number of years.

Except for the $100,000 minimum accumulated earnings credit, it is anticipated that the members of the affiliated group will be permitted to apportion the $100,000 exemptions, limitations, or the $400,000 limitation in any manner that they see fit.

Life insurance companies and mutual casualty insurance companies may not file a consolidated return with any other companies except other life insurance companies of the same type. Under your committee's amendment, however, dividends from, or to, such insurance companies are eligible for the 100-percent dividends received deduction if the entire affiliated group of which the insurance company is a member consents to the tax treatment provided by this section.

(*c*)(*i*) *Effective date.*—This 100-percent dividend deduction treatment is to apply with respect to dividends received in taxable years ending after December 31, 1963.

(*d*) *Revenue effect.*—It is anticipated that this provision will result in a revenue loss of approximately $5 million a year.

20. Interest on loans on certain insurance and annuity contracts (sec. 216 of the bill and sec. 264 of the code)

(*a*) *Present law.*—Under existing law, no interest deduction is allowed in the case of indebtedness incurred or continued to purchase, or carry, a single-premium life insurance, endowment, or annuity contract. In addition, if substantially all the premiums on a contract are paid within 4 years of the date on which the contract was purchased, the contract is treated as if it were a single-premium contract for purposes of this provision. Similarly, where a purchaser borrows an amount equal to a substantial portion of the premium payments on a contract, but, instead of purchasing the policy outright, deposits the borrowed funds with the insurance company for future payments on a policy, this also is treated as if it were a single-premium contract and the interest deduction on the indebtedness relating to the contract is denied. However, under present law, no interest deductions are denied where the taxpayer purchases an insurance contract with the intention of borrowing the maximum amount on the contract each year, unless the contract falls in one of the categories described above.

(*b*) *General reasons for provision.*—It is understood that life, or other insurance policies are being sold to individuals on the basis that they cost the individual little or nothing, and in some cases on the

grounds that they actually result in a net profit for him. In such cases, the taxpayer each year borrows all, or a substantial part, of the funds necessary to pay the premium on the policy. If he is in a 50-percent (or higher) tax bracket, since the interest payments on such loans are presently deductible, the net interest cost to him is one-half or less of the interest payments he makes. The annual increase in the cash value of the insurance policy to reflect interest earnings, which generally is not taxable to the taxpayer either currently or otherwise, is likely to equal or exceed the net interest charges the taxpayer pays. Thus, for taxpayers in higher brackets, where the annual increment in the value of the policy, apart from the premiums, exceeds the net interest cost of the borrowing, such policies can actually result in a net profit for those insured. Because of this, some insurance companies have sold insurance policies under plans which provide for the taxpayer borrowing the premiums either directly from the insurer, or from a bank or otherwise, primarily on the grounds that the policies are tax-saving devices. Both the House and your committee doubt that the sale of insurance on such a basis is either desirable or fair to taxpayers generally.

However, the importance of being able to borrow on insurance policies is recognized; and, therefore, while adopting a provision designed at minimizing the sale of insurance as a tax-saving device, the House and your committee have been careful in this provision to provide for the retention of rights to borrow on insurance for other than tax-saving purposes without the loss of the interest deduction.

One of the Treasury's proposals on which neither the House nor your committee took any action involves the tax treatment of split-dollar life insurance arrangements, which are closely related to this bank loan insurance provision. These are arrangements entered into jointly by an employer and employee under which part of the premiums on a life insurance policy are paid by each. It is believed that the issues involved in this problem, and the proper solution, including the possibility of administrative action, are in need of further study by the Treasury Department.

(c) *General explanation of provision.*—Both the House and your committee's bill provide that interest paid on indebtedness incurred or continued to pay premiums on life insurance contracts, endowment contracts, or an annuity is not to be deductible if the individual is following a plan of systematically borrowing amounts equal to the increase in the cash value of the insurance contract to pay part or all of the premiums. The interest deduction is to be denied whether the borrowing is direct or indirect; that is, whether it is from the insurance carrier, from a bank, or from any other person. It also is intended to cover cases where the individual borrows on other property or on his general line of credit to pay the premiums. This provision is not to apply to a single-premium contract or to a contract treated like a single-premium contract, since present law already denies a deduction in these cases.

In effect, where the taxpayer systematically borrows the increase in the cash value of his policy he is converting what generally is a permanent form of life insurance into substantially the equivalent of renewable term insurance. In this case, however, he retains the right to restore the contract to permanent insurance as of the original

age at which he took out the contract by repaying the amount borrowed from the insurance company, bank, or other person.

The House bill would apply only to insurance or annuity contracts purchased after August 6, 1963, the date the House Committee on Ways and Means first announced its action on this matter. Your committee has amended the provision so that it will apply only to contracts purchased after December 31, 1963, to bring this provision into line with the general effective dates provided in this bill for structural changes. In any event, both the House provision and the provision as amended by your committee will only affect contracts entered into after the specified date and will have no effect on contracts entered into before that date even in the case of borrowings on such a contract in the future.

(c)(i) *Exceptions.*—Both the House and your committee desire to be sure that the value of insurance generally would not be decreased by reducing the rights of the individual to borrow on the insurance, as he can in the case of other forms of assets. For this reason, a number of exceptions to the general rule are added where, even though the borrowing may take the form of a systematic plan, nevertheless this provision is not to apply. These exceptions are as follows:

1. The interest deduction is to be allowed if there is no borrowing with respect to any four of the annual premiums payable on the insurance or annuity contract in the first 7 years of the contract. However, to prevent avoidance of this provision by taking out a contract with very low premiums for the first 4 years, with the premiums being substantially greater thereafter, the bill contains a rule relating to situations of this type. It is provided that the 7-year period referred to above is to commence again at any time there is a substantial increase in the premiums payable under the insurance or annuity contract.

2. A de minimis rule is to apply. Thus, if the otherwise nondeductible interest of an individual with respect to an entire taxable year does not exceed $100, no interest deduction will be denied.

3. In any event, no interest deduction will be denied if the debt was incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in financial obligations. Thus, for example, the interest deduction would not be denied where the individual systematically borrowed on a policy previously purchased because he, or his family, incurred large unforeseen medical bills or because he unexpectedly lost a substantial income source.

4. The interest deduction is not to be denied where the indebtedness actually is to finance business obligations, rather than to carry insurance. For example, an individual with an insurance policy would not have his interest deductions denied where it can be shown that the amounts borrowed by him were actually used to finance the expansion of inventory or for other similar business needs.

(c)(ii) *Effective date.*—This provision as amended by your committee applies to amounts paid in taxable years beginning after December 31, 1963, but with respect to policies purchased after December 31, 1963.

(d) *Revenue effect.*—It is estimated that this provision will result in an annual revenue gain of $5 million in 1964 and 1965 and $10 million when the provision is fully effective.

21. Interest on indebtedness incurred or continued to purchase or carry tax-exempt bonds (sec. 217 of the bill and sec. 265(2) of the code)

(*a*) *Present law.*—Under present law, no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from Federal income taxes. It has been held that interest paid on indebtedness represented by deposits in banks engaged in the general banking business is not subject to this provision since this indebtedness is not considered to be "incurred or continued to purchase or carry" tax-exempt obligations. This position which has been a long-standing administrative practice was specified by ruling in 1961 (Rev. Rul. 61-222, 1961-2 CB58).

(*b*) *General reasons for provision.*—A witness before your committee called attention to the fact that financial institutions which are subject to the banking laws of a State, although not actually banks themselves, pay interest on face amount certificates—a way by which thousands of individuals throughout the country systematically invest their savings. In the example cited to your committee, a certificate holder pays to the financial institution equal monthly payments for 20 years and at the end of that time, the financial institution pays back the amount of the investment plus interest in accordance with the provisions of the certificate. The funds of the financial institution in this case are subject to regulation by the Investment Company Act which permits investment of the funds received from the certificate holder in "qualified investments."

Qualified investments for this purpose include real estate mortgages, certain property improvement loans, U.S. Government and municipal bonds, and other securities meeting certain performance standards. As a result, part of the financial institution's funds are invested in State and municipal bonds, the interest on which is exempt from Federal income tax.

Your committee concluded that in cases of this type the relationship of the financial institution to the certificate holder is sufficiently close to the relationship of a bank to its depositors as to permit the investment of a substantial portion of the funds of such an institution in tax-exempt State and municipal bonds without this resulting in the possible denial of the interest deduction with respect to amounts paid out to the certificate holders. Your committee therefore has amended the House bill to provide that interest deductions are not to be denied in the case of these types of financial institutions to the extent they invest not more than 25 percent of their assets in tax-exempt obligations.

Your committee intends that no inference be drawn from the fact that it has provided this treatment for the future as to the proper interpretation of the applicable law with respect to interest deductions for any prior year.

(*c*) *General explanation of provision.*—Your committee's amendment adds a sentence to the provision of existing law which denies a deduction for interest on indebtedness incurred or continued to purchase or carry obligations, the interest on which is wholly exempt from Federal income tax. The sentence added provides that financial institutions which are subject to the banking laws of the State in which they are incorporated are not to be denied interest deductions on face amount certificates (as defined in the Investment Company Act of 1940), or on amounts received for the purchase of these certificates, on the grounds that this interest is on indebtedness incurred or continued to

purchase or carry tax-exempt obligations. However, interest on these face-amount certificates is to be so treated only to the extent that the average amount of tax investments of the institution in the tax-exempt obligations do not comprise more than 25 percent of the average of the total assets of the institution. "Total assets" for this purpose means gross assets (taken at cost) less all of the liabilities other than the liability on the face-amount certificates.

(*c*)(*i*) *Effective date.*—This provision applies with respect to taxable years ending after the date of enactment of this bill.

(*d*) *Revenue effect.*—It is expected that this provision will result in a negligible revenue loss.

22. Repeal of requirement of allocation of certain traveling expenses (sec. 218 of the bill and sec. 274(c) of the code)

(*a*) *Present law.*—In the Revenue Act of 1962, Congress provided that where a person takes a business trip and this is combined with recreational or other personal activities, the cost of this trip in certain cases must be allocated between the business and personal activity, the former, but not the latter, being deductible for income tax purposes.

Exceptions in the statute provide that this allocation is not to be required where the trip does not take more than a week or where the time spent on the personal activities represents less than a quarter of the time away from home on the trip. In these cases, the entire expenses of travel, and meals and lodging while in travel status, are deductible as under prior law, where the taxpayer can establish that the trip is related primarily to business. Under the authority provided for prescribing, under regulation by the Secretary or his delegate, the amount of activity allocable to the trade or business, the Treasury Department has held that if the travel expense qualifies as an ordinary and necessary business expense, none of it will be disallowed (1) if the taxpayer does not have substantial control over arranging the business trip or (2) if he does not have the obtaining of a personal vacation as a major consideration in determining whether to make the trip.[1] The Internal Revenue Service has held that an employee who is reimbursed by his employer for his travel expenses is considered not to have substantial control over arranging the business trip providing he is not a managing executive of, or closely related to, his employer. Even a managing executive, or an individual who is closely related to his employer, is not affected if he can establish that he did not have substantial control over arranging the particular trip.[2] It is also indicated that mere control over the timing of a business trip will not itself represent substantial control.[3] Even where the person has substantial control over arranging the business-vacation trip, the Service has indicated that it will not be held to be partially allocable to nonbusiness activity unless obtaining a personal vacation or holiday was a major consideration in making the trip.[4] The Service has also indicated that if a major consideration in making the business trip is to visit a hospitalized relative, this will not result in any allocation of the travel expense for personal reasons. On the other hand, of course, if the primary purpose of the trip is to visit an ill relative

[1] U.S. Treasury Department, Internal Revenue Service, "Questions and Answers for the Businessman Travel, Entertainment and Gift Expenses," Document No. 5495 (7-30-63), question No. 69.
[2] Op. cit., question No. 71.
[3] Op. cit., question No. 73.
[4] Op. cit., question No. 75.

for personal reasons, no deduction would be allowable for travel expense as under prior law.[5]

(*b*) *General reasons for the provision.*—There is at the present time a great deal of confusion as to the area of application of this provision and the rules developed by the Internal Revenue Service with respect to this provision are little understood by the general public. It is recognized that the Internal Revenue Service in its interpretation of this provision has attempted to remove the harsher aspects in its application. However, this also has had the unfortunate effect of complicating the provision to such a degree that it is not generally understood by the traveling public. Moreover, the area of application of the provision is so restricted, since it applies only to self-employed persons and to employees who are managing executives or related to employer, and in many cases not to them, that your committee concluded that the provision in its present form served little purpose. In view of these considerations your committee has added a section to the bill repealing this travel allocation rule retroactively to the date of its enactment in the Revenue Act of 1962.

(*c*) *General explanation of provision.*—The section added by your committee repeals the subsection adopted in 1962 which required a person taking a business trip, which was also combined with recreational or other personal activities, to allocate the cost of the trip between the business and personal activities, deducting the former and not the latter. This allocation was not required where the trip does not take more than a week or where the time spent on personal activity represents less than a quarter of the time away from home on the trip.

(*c*)(*i*) *Effective date.*—This provision is repealed as of the date of its enactment; namely, for periods after December 31, 1962.

(*d*) *Revenue effect.*—It is estimated that the repeal of this provision will result in a revenue loss of $5 million a year.

23. Acquisition of stock in exchange for stock of corporation which is in control of acquiring corporation (sec. 219 of the bill and sec. 368 of the code)

(*a*) *Present law.*—Under present law, a subsidiary corporation can acquire the assets of another corporation in exchange for its parent company's stock. This is a tax-free reorganization (under sec. 368(a)(1)(C)). In addition, following this tax-free reorganization the acquired assets can be transferred to a subsidiary corporation without affecting the tax-free nature of the reorganization.

Under present law, it is not possible, however, for a subsidiary corporation to acquire tax free the stock of another corporation in exchange for the stock of its parent corporation. In such a case, for the reorganization to be tax free, present law requires that the subsidiary corporation transfer its own stock in exchange for the stock of the other corporation, rather than the stock of its parent.

(*b*) *General reasons for provision.*—The Supreme Court in *Groman* v. *Helvering* (302 U.S. 82) and *Helvering* v. *Bashford* (302 U.S. 454), found that exchanges in which the parent corporation transferred stock while its subsidiary corporation received stock or the assets of another corporation did not qualify as tax-free reorganizations because the required "continuity of interest" was lacking.

[5] Op. cit., question No. 76.

In the 1954 code, in order to avoid the results of the *Groman* and *Bashford* decisions, the law was amended to provide that the subsidiary corporation could acquire the assets of another corporation in exchange for its parent corporation's stock (in tax-free reorganization under sec. 368(a)(1)(C)). The 1954 code also provided that following this reorganization, the acquired assets could be transferred to a subsidiary corporation without destroying the tax-free status of the reorganization.

Thus, the 1954 code permits tax-free reorganizations in the case of the exchange of the parent's stock for the assets of a corporation acquired by the subsidiary. However, a similar result is denied where the subsidiary acquires the stock of the other corporation in exchange for the stock of its parent corporation. Since Congress has considered the "continuity of interest" rule satisfied in the case of asset acquisitions, there seems to be no reason for not applying the same rule to stock acquisitions, since there is little in substance to distinguish an asset acquisition from a stock acquisition.

As a result, your committee has concluded that it is desirable to treat these two types of acquisitions in the same manner. For that reason, it has provided tax-free status for the stock-for-stock reorganization in the same manner that present law provides a tax-free status for stock-for-assets reorganizations.

(*c*) *General explanation of provision.*—This provision amends the definition of a stock-for-stock reorganization (known as a (B) reorganization) to qualify as a tax-free reorganization a transaction in which a subsidiary corporation acquires the stock of another corporation (and after that is in control of the corporation) in exchange solely for the voting stock of its parent corporation. Present law is also amended to permit the subsidiary corporation acquiring the stock of another corporation in the "(B) reorganization" to transfer all or part of this stock to another corporation which it controls. In addition, conforming changes have been made to the definition of the term "party to the reorganization".

(*c*)(*i*) *Effective date.*—The amendment made by this provision applies with respect to transactions after December 31, 1963.

(*d*) *Revenue effect.*—This amendment is expected to result in a negligible loss in revenue.

24. Retroactive qualification of certain union negotiated multiemployer pension plans (sec. 220 of the bill and sec. 401(i) of the code)

(*a*) *Present law.*—Under present law, a pension trust is qualified for income tax exemption only if it meets certain requirements relating to coverage of employees and nondiscrimination of contributions or benefits. Where the pension trust is properly qualified, not only is it exempt from Federal taxation with respect to its income, but contributions paid to it by an employer on behalf of his employees are deductible for Federal income tax purposes. Thus, it is of great importance for a pension trust to meet the requirements of the Internal Revenue Code and thereby become a qualified trust.

(*b*) *General reasons for provision.*—On several occasions in recent years bills have been presented to Congress and enacted into law providing for the retroactive qualification of specific pension trusts which could not initially qualify for exemption but after a period of time were able to do so. An example of this is the pension plan of local union No. 435, International Hod Carriers Building and Com-

mon Laborers' Union of America which was retroactively made a qualified trust by Congress in section 25 of the Revenue Act of 1962.

These plans are multiemployer pension plans established under colective bargaining agreements between a union and several employers. The regulations under present law (Regulations sec. 1.401-1(a)(2)) require that a "definite written program and arrangement" be communicated to the employees. This requirement cannot be met without delay in many cases of these multiemployer pension funds. However, the employers are required by the collective bargaining agreement entered into to begin making contributions under a general formula when the agreement is signed. However, to determine a schedule of benefits under one of these plans, frequently a complex actuarial study must be made, including a census of the employees of all of the participating employers. This requires a substantial period of time and during this period there can be no "definite written program." Therefore, there cannot be a qualified plan during this period and the contributions required under the union agreement, where they are not vested, cannot be deducted by the employers.

Because of the severe consequences of the failure to qualify for deductions during this period, Congress has from time to time provided retroactive qualification of plans where they subsequently become qualified and where the pension trust in the meanwhile was not operated in a manner which jeopardized the interests of its beneficiaries. To make it unnecessary to consider each one of these plans separately for retroactive qualification, the Treasury Department has recommended to Congress that it be given general authority to qualify these plans retroactively to the date of their creation where certain tests are met: The plans subsequently must become qualified and in the interval the trust must have been operated in a manner which substantially meets the tests under which the plan subsequently qualifies and the interests of the beneficiaries during this period must not in any way have been jeopardized. Your committee is in accord with the Treasury Department's recommendation and, therefore, has added a new section to this bill to provide retroactive qualification for these plans in such cases.

(c) *General explanation of provision.*—Your committee's amendments provide that a trust which is a part of a pension plan which the Secretary has found to be a "qualified trust" and one which is itself exempt from taxation is to be considered as a trust which was a "qualified trust" and as one which was exempt from taxation from the period beginning with the date when contributions were first made to the trust rather than beginning with the date that the trust otherwise first constituted a "qualified trust".

For this retroactive qualification to be made available to a pension trust, it must be established to the satisfaction of the Secretary of the Treasury or his delegate that three conditions have been met. First, he must be satisfied that the trust was created under a collective bargaining agreement with two or more employers who are not related. This provision is made available only in the case of multiemployer plans because it is believed that only these plans involve the substantial delay after the bargaining agreement before it is possible to determine the schedule of benefits for the employees. Moreover, present law already provides that single employer plans may be retroactively qualified to the beginning of a year if the qualifications

are fully met by the 15th day of the third month following the close of a year.

Second, it must be shown to the satisfaction of the Secretary or his delegate that the disbursements made from the trust prior to actual qualification substantially meet the tests under which the pension plan subsequently qualifies. Minor variations, not basically discriminatory in character, for this purpose may be ignored.

Third, the Secretary or his delegate must be satisfied that prior to the time the trust constituted a qualified plan the contributions made to this trust were not used in a manner which would jeopardize the interests of the beneficiaries.

These are essentially the same conditions which previously, when plans were considered on an individual basis, Congress has required to be met before retroactive approval was accorded these plans.

(c)(i) Effective date.—This provision is to apply retroactively back to what was the general effective date of the Internal Revenue Code of 1954; namely, taxable years beginning after December 31, 1953, and ending after August 16, 1954, but only with respect to contributions made after December 31, 1954.

(d) Revenue effect.—It is believed that this provision will result in a negligible loss of revenue.

25. Qualified pension, etc., plan coverage for employees of foreign subsidiaries and domestic subsidiaries operating abroad (sec. 221 of the bill and secs. 406 and 407 of the code)

(a) Present law.—Under present law, a domestic corporation may extend old-age and survivors insurance coverage to U.S. citizens employed by its foreign subsidiaries. This social security coverage can be provided by agreements between the parent company and the Secretary of the Treasury or his delegate. This coverage is available only to U.S. citizens employed by foreign subsidiaries in which the domestic corporation has at least a 20-percent voting stock interest or a foreign subsidiary of such a foreign subsidiary if the first subsidiary has at least a 50-percent voting stock interest in the second. Of course, U.S. citizens in a domestic corporation, even though that domestic corporation is operating abroad, also are covered under present law for social security purposes.

There is no method comparable to the social security agreement referred to above for covering under a domestic corporation's qualified pension profit-sharing stock bonus, annuity, or bond purchase plan the U.S. citizens who are employees of its foreign subsidiaries. If a U.S. citizen becomes an employee of the foreign subsidiary, he is no longer eligible to participate in the pension or profit-sharing plan of the domestic parent corporation. Moreover, the foreign subsidiary corporation cannot establish a similar pension, etc., plan and obtain qualifications from the Internal Revenue Service unless it includes in this plan the foreign nationals on its payroll on a nondiscriminatory basis. Where the plan is not qualified, the U.S. citizens of such a foreign subsidiary under present law would be currently taxable on any contributions made by the foreign subsidiary to a pension or profit-sharing plan to which they had nonforfeitable rights.

Similarly, it has been held by some Internal Revenue offices that a domestic corporation operating abroad through branches cannot obtain qualified status plans which provide coverage for U.S. citizens

who are employees of the domestic corporation, unless it also provides nondiscriminatory coverage for the foreign employees on its payroll.

(*b*) *General reasons for provision.*—Your committee believes that it should be possible to cover under qualified plans U.S. citizens who are employees of foreign subsidiaries in substantially the same manner as it is possible to cover them by agreement under present law for social security purposes. It is believed that it should be possible to cover the U.S. citizens under a qualified plan for U.S. tax purposes without also covering the foreign nationals of the foreign subsidiary under such a plan. The foreign nationals usually are interested in different patterns of retirement benefits depending upon their own local custom; on the other hand, the U.S. citizen employed by the foreign subsidiary has close economic and personal ties with the United States, expects to return home, and may well wish to continue coverage under a qualified plan of the domestic parent corporation under which he was covered before becoming an employee of the foreign subsidiary.

The problem is substantially similar in the case of U.S. citizens employed abroad by foreign branches of domestic subsidiaries. They are covered for social security purposes and should in your committee's view have an opportunity to be covered under qualified plans in the same way as is proposed in the case of employees of foreign subsidiaries of domestic corporations.

(*c*) *General explanation.*—For the reasons given above, your committee has added an amendment to the House bill providing that U.S. citizens who are employees of foreign subsidiaries of a domestic corporation may under certain circumstances be included for coverage under a qualified pension or annuity plan or profit-sharing or stock bonus or bond-purchase plan or stock bonus plan of the domestic corporation. Thus, contributions made to such a plan for the U.S. citizens employed abroad by the domestic corporation will not be taxable to the employee at the time of contribution even though his rights in the contribution are nonforfeitable and the qualified status of the plan will not be disturbed.

To qualify for this treatment, the individual involved must be a citizen of the United States and an employee of a foreign subsidiary of a domestic corporation. The domestic corporation in this case must have entered into an agreement with the Treasury Department to cover for social security purposes the U.S. citizens who are employees of the foreign corporation involved, and the pension, profit-sharing or stock bonus plan of the domestic corporation must provide coverage for employees of all of its foreign subsidiaries with which it has entered into an agreement to provide social security coverage. In addition the individual involved must not be covered under any other employer's funded plan of deferred compensation such as a pension or profit-sharing or stock bonus plan (qualified or not) with respect to the compensation he receives from the foreign subsidiary. A foreign subsidiary for this purpose is defined in the same manner as is provided for in the case of social security coverage of U.S. citizens who are employees of a foreign subsidiary. Thus, the parent corporation must have a 20-percent voting stock interest in the foreign subsidiary. Also covered are subsidiaries of such a foreign subsidiary where the first foreign subsidiary has at least a 50-percent voting stock interest in the second.

Your committee's amendment also provides that employees of a domestic subsidiary of a domestic parent corporation may be covered

under the domestic parent corporation's pension or annuity plan, profit-sharing plan, stock bonus or bond-purchase plan where the individual involved is a U.S. citizen and the domestic subsidiary's operation is largely through foreign branches. Here, of course, coverage for social security purposes is automatically provided since the subsidiary corporation involved is a domestic corporation. In other respects, however, the conditions which must be met are substantially the same as those specified above in the case of the foreign subsidiary. Thus, the pension or profit-sharing plan of the domestic parent corporation must provide for coverage for employees of all domestic subsidiaries (meeting the definition specified below) who are citizens of the United States. Also the compensation paid by the domestic subsidiary operating abroad to the employee must not be covered under any other funded pension, profit-sharing or other type of plan of deferred compensation.

The definition of a domestic subsidiary whose operations are largely foreign approximates the requirements under present law specified with respect to Western Hemisphere trade corporations except that there is no geographical limitation to the Western Hemisphere. Thus, 95 percent or more of its gross income for the taxable year and 2 prior years must be derived from sources without the United States and 90 percent or more of its gross income for this same period must be derived from the active conduct of a trade or business. In addition, its voting stock must be held to the extent of 80 percent or more by the domestic parent corporation (as contrasted to the 20-percent requirement in the case of the foreign subsidiary).

Although the U.S. citizen who is an employee of either the foreign subsidiary or the domestic subsidiaries operating abroad is to receive the benefit of tax postponement with respect to contributions made by the domestic parent corporation to the qualified pension or profit-sharing plan, the domestic parent corporation is not to receive a deduction for its contribution to the plan since this is compensation provided with respect to an employee of its subsidiary. Generally, the domestic parent corporation, to the extent of these contributions, will be treated as having made a contribution of capital to its foreign subsidiary or domestic subsidiary operating abroad. Then this amount will be treated as a deduction to the subsidiary (to the extent it is subject to U.S. tax). In any event, this amount will decrease the earnings and profits account of the subsidiary.

Although the deduction in this case is denied the domestic parent corporation for purposes of all other tests as to the status of the pension or profit-sharing fund, including funding for back years as to which no benefits were provided under any funded plan of deferred compensation, the contribution to the plan with respect to these U.S. citizens employed abroad will be treated in the same manner as other contributions to the fund by the domestic parent corporation. The individual involved will also be treated as if he were an employee of the domestic parent corporation for purposes of the annuity provisions of the code (sec. 72 (d), (f)), the section providing up to $5,000 of tax-free benefits upon an employee's death (sec. 101(b)) and for purposes of the treatment of annuities received under qualified plans for purposes of the estate and gift taxes (secs. 2039 and 2517).

In testing to be sure that a plan is not discriminatory, officers, shareholders, supervisory personnel, etc., of the subsidiary will be

treated as if they had the same status with respect to the domestic corporation, and the determination as to whether an individual is highly compensated or not will be made on the basis of what the individual's status would be if he were an employee of the domestic parent corporation. Similarly, what is treated as compensation to the employee for purposes of a qualified plan is to be determined on the basis of his compensation received from the foreign or domestic subsidiary corporation. If part of this compensation is received in foreign currency, this compensation will be valued under existing law for purposes of this provision.

(c)(i) *Effective date.*—The general effective date for these provisions is to be taxable years ending after December 31, 1963.

(d) *Revenue effect.*—It is expected that this provision will result in a negligible loss of revenue.

26. Employee stock options and purchase plans (sec. 222 of the bill and secs. 421–425 of the code)

(a) *Present law.*—Under present law, no income tax is imposed in the case of employee restricted stock options, either when the option is granted or at the time it is exercised. Instead, tax generally is imposed at the time the stock involved is sold by the employee. In the case of those stock options where the option price is at least 95 percent of the market price of the stock at the time the option is granted, the entire amount of any gain realized by the employee at the time he sells the stock is treated as capital gain. Where the stock option price is between 85 and 95 percent of the market price at the time the option is granted, the difference between the option price and the market value of stock at the time of the grant of the option is treated as ordinary income. However, this ordinary income is not realized for tax purposes until the employee sells the stock.[1] Any additional gain at the time the stock is sold in such cases is treated as capital gain. In the case of these restricted stock options, employers are not allowed any deduction for the amount of the gain realized by the employee, whether this gain is treated as capital gain or ordinary income.

For a stock option to be classified as a restricted stock option and be eligible for the treatment outlined above, the option price must be at least 85 percent of the market price of the stock at the time the option was granted, the stock and/or the option must be held by the employee for at least 2 years after the date of the granting of the option and the stock held for at least 6 months after it is transferred to him, the option must not be transferable other than at death, the individual may not be a 10-percent shareholder in the corporation (unless the option price is at least 110 percent of the fair market value) and the option must not be for a period of more than 10 years.

(b) *General reasons for provisions.*—The administration recommended the repeal of the stock option provision altogether. This recommendation was made on the grounds that stock options were compensatory in nature and, therefore, should be treated in the same manner as wages and salaries. It was suggested that with the lower tax rates provided by this bill, compensation received in this manner no longer required special treatment.

[1] If the gain is less than the spread between the option price and the fair market value at the time the option is granted, this lesser amount is taxed as ordinary income.

The House, however, decided to continue the stock option provision because it believed that it is good for the economy for management of various businesses to have a stake in their successful operation. The House believed that this provides important incentives to expand and improve the profit positions of the companies involved. It was suggested that this is not only good for the specific business involved, but also for the economy as a whole. Despite the fact that the House continued the stock option provision, however, it was recognized that there are abuse situations in the present provisions which need correcting. The House bill was directed toward such corrections. Your committee is in accord with this position and has, therefore, with relatively minor changes retained the House bill.

Although the use of stock options generally is thought of in terms of providing incentives for key executives in a business, what are presently called restricted stock options also are used by some companies for an entirely different purpose. Some companies have made stock options available to all, or practically all, of their employees Taking advantage of the fact that the option may be granted at 85 percent of the market price they make discount sales of the stock to their employees generally. These are known as employee stock purchase plans. Where stock options are used in this manner, they are designed primarily as a means of raising capital; and, in such cases, the discounts from market price made available to the employees usually correspond approximately with the costs the company would otherwise incur in floating a new stock issue.

In practice, the House and your committee found that quite different features are required for key employee stock options and the discount purchase plans made available to employees generally. For that reason, the two types of options are placed in separate sections setting forth substantially different requirements for each. In the case of the key employee stock options or "qualified stock options" as they are called by the bill for future years—

1. The period over which the stock must be held has been increased to 3 years. This is designed to give assurance that the key employees actually are acquiring a "stake in the business" and are not merely turning the stock over as fast as the options can be exercised.

2. The maximum period of time over which an option may be outstanding has been reduced from 10 years to 5. It is recognized that stock options historically have a much greater value to the individual if the period of time over which they may be exercised is a long period, since over most 10-year periods stock values have risen. Thus, where the option may be exercised over a very long period of time, such as 10 years, its grant appears more closely associated with compensation and less directed toward the individual efforts of the employee involved. Furthermore, the purpose of the provisions is to encourage the acquisition of a proprietary interest in the business as quickly as possible.

3. The options must be issued at 100 percent of the market price rather than 85 percent (with a special rule where the price inadvertently is set below 100 percent). Closely associated with this also is the removal of the variable price stock option provision. These modifications are made to decrease the compensatory nature of the existing stock option provision and to place

greater emphasis on the employee's efforts to improve his company's business and thereby raise the price level of the stock.

4. Provisions have been added to limit the extent to which new options may be exercised where old options previously were issued, but had become less attractive than a new option because of a decline in the market price of the stock in the interval between the issuance of the two. Existing law already limits the resetting of options below the original price of issue where the stock has declined. This modification achieves the result intended, but not obtained, by existing law. Your committee has adjusted this House provision in two respects to eliminate what it believes were unintended, harsh results under the House bill.

5. Stockholder approval is required for stock option plans to give assurance that the benefits granted management in the case of these options is in accordance with the desires of the stockholders.

6. The bill also provides that stock options generally are not to be made available to employees with stockholdings of more than 5 percent (although to a limited extent, they may be made available in the case of small business to those with holdings up to 10 percent). Under present law, stock options may be granted to employees with stockholdings of more than 10 percent only at a price 10 percent above the market price. It was thought unnecessary to provide employees who are substantial stockholders with any incentive to improve the business since they already have a substantial stake in its successful operation.

In the case of the employee stock purchase plans, existing law is continued (in a separate section) without major modification. In this case, for example, employees will continue to be able to purchase stock through options at a price as low as 85 percent of the market price of the stock at the time the option is issued since these plans, as previously indicated, are in the nature of "discount" purchase plans. However, to qualify for treatment under the employee stock purchase plans, a series of new conditions must be met, designed primarily to establish that the purchase plans are made available without discrimination to most employees of the corporation.

(c) *General explanation of provisions.*—The bill divides the tax treatment of employee stock options and purchase plans into five provisions: First are the general rules applicable to both; second, the special rules applicable to qualified stock options (i.e., those for key employees which are granted after December 31, 1963, under your committee's amendments, or June 11, 1963, under the House bill) third, the special rules applicable to employee stock purchase plans (in general, those granted after the date specified above); fourth, restricted stock options (which cover both of the two categories mentioned immediately above but only for options issued before the specified date); and fifth, certain definitions and special rules applicable to stock option and stock purchase plans in both the past and the future. The material presented below deals first with qualified stock options and then with employee stock purchase plans. The provisions dealing with restricted stock options, which are only those options issued in the past, are covered by a continuation of existing law and are not dealt with here.

(c)(i) *Qualified stock options: tax treatment.*—Generally, in the case of qualified stock options, no income tax is imposed either at the time

the option is granted or at the time the option is exercised and the stock is transferred to the employee. Similarly, no business expense deduction is allowed to the employer corporation (or a parent or subsidiary of that corporation) at any time with respect to this option.

There is, however, an exception to the general rule that no tax is imposed at the time of the exercise of the option. As is indicated below, one of the requirements of a qualified option is that the price under the option is not to be less than the fair market value of the stock at the time the option is granted. An exception to this, however, is provided where there was an attempt made in good faith to price the option at the market value of the stock but the market value was underestimated. This, of course, would ordinarily occur only in the case of unlisted stock. In such cases the option will not be disqualified, but 1½ times the difference between the option price and what actually is the fair market value of the stock at the time the option is granted (or the difference between the option price and fair market value at the time of exercise, if this is smaller) is to be taxed as ordinary income at the time the option is exercised. This is intended to discourage any attempts at undervaluing the stock, without disqualifying the options where the undervaluation was unintentional.

Another limitation on a qualified stock option (set forth below) is that the stock must be held for at least 3 years. The bill provides that in those cases where it is not held for this 3-year period, the option will still be a qualified option, but the spread between the option price and the value of the stock at the time the option is exercised will be treated as ordinary income at the time the stock is sold. However, in such cases the employee will never be taxed on more than his gain. Thus, if the price of the stock has fallen since the time of the exercise of the option, the amount of the ordinary income will be limited to the difference between the option price and the actual price of the stock on the date of sale. Where the price of the stock at the time of sale is less than the option price, there will be no ordinary income and the difference between the option price and the price at which the stock is sold will be treated as a capital loss. On the other hand, if the stock is sold at a price which is higher than the price on the date the option was exercised, then in addition to the amount treated as ordinary income (the difference between the option price and value on the date of exercise) there will be an amount treated as a capital gain.

The determination of the type of capital gain, i.e., whether short term or long term will depend on the length of time the stock has been held. Thus, any gain where the stock has been held beyond the 3-year period specified with respect to qualified stock options will result in long-term gain with a 50-percent inclusion factor and a 25-percent maximum tax. Where the stock is disposed of in less than 3 years and, in addition to the amount treated as ordinary income, there is an amount treated as capital gain, this capital gain will be either short term (if the stock is held 6 months or less) or long term (if it is held more than 6 months).

As under present law, where the employee dies after having purchased the stock but before holding it for the specified period of time, this holding period is waived since there is no business reason for

requiring the estate or heir to hold the stock. Similarly, a requirement subsequently referred to that the individual must be in the employ of the corporation involved up to 3 months before the date of exercise of the option also is waived in the case of the death of the employee before exercise.

A transfer to a trustee in bankruptcy (or a similar fiduciary) of shares of stock acquired under a qualified stock option is not considered to be a "disposition" of such share so there will be no ordinary income recognized at that time, although a capital gains tax may be due.

(c)(ii) Qualified stock options: conditions for qualification.—For an individual to receive full qualified stock option treatment, he must not sell (or otherwise dispose of) his stock within 3 years of the date of exercise of the stock option. As indicated previously, where all conditions but this one are met, tax is not imposed until the sale of the stock, but much or all of the tax imposed at that time, if this condition is not met, will be on the basis of ordinary income rather than capital gain. This condition is designed to give assurance that the key executive involved actually maintains a "stake in the business" and is not merely selling the stock shortly after he receives it, thus vitiating the principal purpose of stock options, and converting ordinary compensation into capital gain. This requirement, of course, is not a new idea since present law already requires the individual to hold the option, or stock, for at least 2 years and the stock alone for 6 months in order to receive restricted stock option treatment.

A second condition which must be met for the option to receive qualified stock option treatment is that the individual involved, for the entire time from the date of the granting of the option until 3 months before the date of the exercise of the option, must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of a corporation) which has assumed the option of another corporation as the result of a corporate reorganization, liquidation, etc. This provision differs only slightly from existing law, which requires that the individual be in the employment specified at the time of the granting of the option and on the day ending 3 months before the exercise of the option but does not require that he be in the specified employment in the intervening time. Of course, for this purpose, military leave or sick leave would not disqualify an individual.

In addition to the requirements referred to above, the terms of the option itself must also meet certain specified conditions in order to be eligible for qualified stock option treatment. They are as follows:

1. The option must be granted under a plan which specifies the number of shares of stock to be issued and the employees or class of employees to receive the options. This plan must be approved by the stockholders of the corporation within 12 months before or after the plan is adopted. If the plan permits stock options to be granted to a class of employees, the class of employees must be described with sufficient particularity to allow the shareholders to make a meaningful decision concerning the plan. The use of a general term such as "key employees" is not a sufficient description of those eligible to receive options. Ordinarily any change in the aggregate number of shares which may be issued under the plan or the employees or class of employees eligible to receive such options will be treated as the adoption

of a new plan. No other change in the terms of a stock option plan will, however, be considered to be the adoption of a new plan.

2. The option must be granted within 10 years of the time the plan is adopted or approved by the stockholders, whichever is the earlier.

3. The option must by its terms be exercisable only within 5 years of the time it is granted.

4. The option price must equal or exceed the fair market value of the stock at the time the option is granted. An exception to this provides that where the option price was less than the market price, but this was unintentional, then this condition is to be considered as met (although as previously indicated, a maximum of 1½ times any difference in price is taxed as ordinary income at the time of the exercise).

5. Generally the option by its terms is not to be exercisable while there is outstanding any qualified stock option or restricted stock option which was granted to the employee at an earlier time. The purpose of this provision is to prevent an individual from indirectly gaining an advantage by the employer in effect resetting the price at which an earlier option was issued by issuing a second option at the lower price. To prevent this a second option may not be exercised during the period the first option under its initial terms could have been exercised unless the first option itself is exercised. Thus, generally a cancellation of the first option will not enable the second option to be exercised any sooner. However, the bill as passed by the House provides that restricted stock options may be canceled any time before January 1, 1965, without affecting adversely the exercise of a qualified stock option subsequently issued. In addition, in the case of a restricted stock option which under its terms is made available to the employee only in installments over an extended period of time, the House bill provides that the installments which cannot yet be exercised at the time of the granting of a new qualified option are not to prevent the exercise of this second option so long as these installments cannot be exercised. Your committee has accepted this general rule of the House bill preventing the "resetting" of option prices and also has accepted the modifications in the general rule provided by the House bill. However, your committee has added two new modifications to provide for situations which it believes were overlooked by the House. First, where the option price for the new option is at least as high as the price of each of the outstanding, previously issued options to purchase the same stock (whether these prior options were qualified options or restricted options), this "reset" rule is not to apply; i.e., the new stock option in such a case can be exercised before the outstanding options. Second, your committee has provided that where an option under the terms under which it was granted is not immediately exercisable in full, the employer can permit the exercise date for any or all of the remaining installments of the options to be accelerated without this change being considered a "modification" which would require a new option price for the option for it to continue to constitute a qualified (or restricted) option. Both of these modifications made by your committee continue the intent of the House provision, in that neither permits the taxpayer to exercise a new option at a lower price than his old option until the old option has been exercised or lapsed. It was thought, however, that there was no need to deny the right to exercise the second option in those

cases where the taxpayer could gain no price advantage from this. Similarly, it was thought that there was no reason why the installments on the first option should not be accelerated where the inability to exercise these installments was preventing the exercise of the new option.[1]

6. The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by him. This provision is the same as under present law.

7. The employee, immediately after the option is granted, must not own stock representing more than 5 percent of the voting power or value of all classes of stock of the employer corporation or its parent or subsidiary. In the case of small businesses, however, the employee may own up to 10 percent of the voting power or value of the stock before being disqualified. For a corporation with equity capital of less than $1 million, this percentage is to be 10 percent and for one with equity capital of $2 million it is to be 5 percent. Between these two levels of equity capital the allowable percentage decreases gradually from the 10-percent level for a company with $1 million of equity capital down to the 5-percent level for a corporation with equity capital of $2 million or more. Equity capital for this purpose is the assets of the corporation, adjusted for any change in their basis, less any indebtedness of the corporation. Where a parent or subsidiary also are involved, adjustments are made to delete intercorporate ownership. For this purpose, the individual is considered to own stock owned directly or indirectly by brothers and sisters, wife, ancestors, and lineal descendants. Stock owned directly or indirectly by a corporation, partnership, estate, or trust for this purpose is considered as being owned proportionately by shareholders, partners, or beneficiaries.

(c)(iii) *Employee stock purchase plans; tax treatment.*—As indicated previously, except for the addition of the nondiscrimination requirement (and the requiring of stockholder approval) the tax treatment of employee stock purchase plans continues to be substantially similar to the tax treatment of restricted stock options under present law. Thus, as under present law, no income is to be reported by the employee either at the time the option is granted or at the time it is exercised. Similarly, no deduction is available to the employer corporation with respect to the employee stock purchase plan.

As under present law, under these purchase plans the option may be issued at a price as low as 85 percent of the market value of the stock at the time of the grant. Where this is done, this spread between the option price and the market value at the time the option is granted, upon the subsequent sale of the stock by the employee or upon the employee's death is treated as ordinary income. However, in no event is the amount to be taxed to the individual as ordinary income to exceed the gain realized on the stock at the time of its disposition.

In addition, ordinary income in the case of employee stock purchase plans may arise where the stock is disposed of before the expiration of the applicable holding period. As under present law, the option and/or stock must be held for a period of at least 2 years and the stock itself held for a period of at least 6 months. Where this holding

[1] This latter rule, of course, applies whether or not a second option is issued; but it is believed that it will have a primary impact in cases of this type.

period is not complied with, then any spread between the option price and the price of the stock at the time the option is exercised will be treated as ordinary income when the stock is sold or otherwise disposed of. As under present law, the specified amount is ordinary income without regard to whether this is greater or less than the gain realized on the stock at the time of the sale. Where the gain otherwise realized is less than this amount treated as ordinary income, the specified amount is still treated as ordinary income but a capital loss is recognized equal to the difference between the market value of the stock at the time of exercise and the sales price of the stock. Apart from these two cases where ordinary income may be realized any other gain recognized on the sale of purchase plan stock results in capital gain.

(c)(*iv*) *Employee stock purchase plans; conditions for qualifications.*— As indicated above, to qualify for purchase plan treatment, the stock in these cases must not be disposed of within 2 years of the date of the granting of the option nor within 6 months after the transfer of the stock to the individual. This is a continuation of existing law.

In addition, the individual must at all times during the period beginning with the date of the granting of the option and ending 3 months prior to the date of exercise, be an employee of the corporation granting the option, a parent or subsidiary of the corporation, or a corporation (or parent or subsidiary of a corporation) which assumed this stock option as a result of a corporate reorganization, liquidation, etc. This provision is the same as that previously described in the case of qualified stock options. As indicated in the case of qualified stock options, this differs only slightly from existing law.

To qualify as an employee stock purchase plan, nine requirements must be met by the plan itself. Alternatively, all but the first two of these may, however, be met in the stock offering rather than the plan. These conditions are as follows:

1. As under present law, the plan must provide that the options are to be granted only to employees of the granted corporation or a parent or subsidiary.

2. The plan must be approved by the stockholders of the corporation granting the option within 12 months before or after the date the plan is adopted. This provision is a new requirement which is the same as that provided in the case of qualified stock options.

3. No employee can be granted an option if he owns 5 percent or more of the voting power or value of all classes of stock of the employer corporation or its parent or subsidiary. Present law provides that employees having more than a 10-percent interest in a corporation may not obtain a restricted stock option at less than 110 percent of the market price of the stock.

4. A new provision designed to prevent discrimination provides that the options must be granted to all employees of the corporation except that there may be excluded one or more of the following four categories:

(*a*) Employees who have been employed less than 2 years;

(*b*) Employees who are part time and employed 20 hours or less per week;

(*c*) Employees whose customary employment is not for more than 5 months a year; and

(*d*) Officers, supervisory personnel, or highly compensated employees.

5. Another new provision designed to give assurance that these stock purchase plans are nondiscriminatory requires that all employees granted options have the same rights and privileges except that the amount of stock which may be purchased by any employee may be a uniform percentage of total compensation or regular or basic compensation and the plan may provide a maximum number or value of shares to be purchased.

6. Under the plan, the option price may not be less than 85 percent of the market value of the stock at the time the option is granted or not less than 85 percent of the market value of the stock at the time the option is exercised, whichever is the lesser. This restriction is similar to the limitations of present law although slightly more restrictive in some cases.

7. The period over which the option may be exercised cannot exceed 5 years where the option price is not less than 85 percent of the value of the stock at the time of the exercise or 27 months from the date of the grant of the option if the option price is at least in part determined on the basis of the price of the stock at the time the option is granted. Present law provides a 10-year period over which restricted stock options may be exercised but in practice it is understood that options issued under purchase plans generally have a much shorter period over which they may be exercised.

8. A new ceiling is provided to the effect that an employee may not purchase stock at an annual rate in excess of $25,000 a year. This restriction is provided since these plans are designed primarily for broad employee participation.

9. As under present law and in the case of the qualified stock options, the option must not be transferable by the individual other than at death and must be exercisable during the employee's life only by him.

(c)(v) Reporting requirements.—The bill provides that corporate employers are to report on the transfer of stock to an employee in the case of the newly established category of qualified stock options or present law restricted stock options. They also are to report on the sale of stock by the employee where stock is acquired under a stock purchase plan at a price less than the full value of the stock and where, under a restricted stock option, stock is purchased at a price between 85 and 95 percent of the value of the stock. In these latter two cases, the report of the sale of the stock by the employee is required since generally in these cases ordinary income tax will be payable by him. A copy of the form of the report going to the Government also is to be sent to the employee or former employee on or before January 31 after the year involved. In those cases where the employer is required to report on the sale of stock by the employee, he will not be expected to follow the ownership of the stock beyond the first transfer; e.g., if an employee transfers stock to a street name and then subsequently sells the stock, the employer will report the first transfer of the stock to the street name but will not be required to report the subsequent sale. Moreover, the reporting in these cases is merely to indicate the name, address, and account number of the individual employee involved and the stock sold by him.

(c)(vi) Effective date.—In the case of qualified options, the House bill generally provided that the new provisions were to apply to options granted to an individual after June 11, 1963. Your committee has amended this to provide that the new provisions with respect to

qualified options are to apply to options granted after December 31, 1963. A binding, written contract entered into before January 1, 1964, will not be considered as giving rise to options which must meet the "qualified option" test. Your committee has provided this new effective date to conform the effective date in this case with the general effective date provided under the bill for structural changes. In addition, it thought that it would be unfair to require taxpayers to conform to a new set of rules during an extended interval of time when the status of the proposals was still uncertain.

Of course, in a transaction which qualified as a tax-free reorganization, where a corporation entered into a binding obligation to assume outstanding restricted stock options previously granted by a corporation, any option which the acquiring corporation issues in assuming the outstanding options already granted by the acquired corporation, to the extent provided by present law, are considered as continuations of the old options and therefore will be considered as granted prior to January 1, 1964, and treated as restricted stock options rather than qualified stock options.

In the case of qualified options, your committee has also added a transition rule. This rule provides that an option which is issued after December 31, 1963, and before January 1, 1965, which does not meet the terms of a "qualified option", can be modified to meet these terms any time before January 1, 1965, without this modification being considered as giving rise to a new option requiring a new option price. This rule is intended to give taxpayers who have their plans already established, or who initially are not aware of the new provision, time to modify their stock options so that the new conditions are met without the options being disqualified as a result.

In the case of employee stock purchase plans, the new provisions under the House bill would apply to options granted after June 11, 1963. Your committee's bill has changed the effective date of the employee stock purchase provision so that it applies to options granted after December 31, 1963, in the same manner as in the case of the qualified options. These same reasons account for this change. Thus, the new employee stock purchase plan provision will apply generally to options granted after December 31, 1963. Existing law, however, will apply to options granted pursuant to a written plan adopted and approved before January 1, 1963, which at that time met the nondiscrimination requirements specified for employee stock purchase plans. A plan which was being administered in a way which did not discriminate in favor of officers, supervisory personnel, or highly compensated employees would continue to qualify as adopted and approved before January 1, 1964. Except for the date, this modification is the same as provided by the House bill. Thus, a plan (not otherwise being discriminatory) would be considered nondiscriminatory even though only full-time employees were covered (rather than those working 20 hours a week or more) or those with less than 6 months a year employment were omitted (rather than those with less than 5 months employment).

(*d*) *Revenue effect.*—The changes made by this provision are not expected to have any appreciable revenue effect. To the extent that the changes made above result in a reduction in stock options issued, this will increase deductions taken by corporations as they make deductible payments to employees in other forms.

27. Installment sales by dealers in personal property (sec. 223 of the bill and sec. 453(a) of the code)

(*a*) *Present law.*—A taxpayer using installment sale reporting can defer income for tax purposes until payments are received under the contract (rather than treating the entire amount as income as of the time the sale is made). This provides the seller with funds with which to pay the tax, while at the same time giving him the immediate advantage of deductions attributable to the sale.

Prior to October 15, 1963, sales under revolving credit plans were not recognized by the Treasury Department as installment sales for tax purposes because of certain differences between revolving credit plans and traditional installment sales. For instance, installment sales ordinarily involve a separate contract for each item of property purchased, providing for a series of payments specifically applicable to the purchase price of that piece of property. Usually the seller also retains some type of security interest in the property, until the property is paid for.

Revolving credit plans, on the other hand, do not involve separate sales contracts; under these plans any item in the store may be charged to the same account, and the seller does not retain any security interest in the property sold. The buyer has an option to pay his account in full within 30 days with no interest or finance charges. Alternatively, he may pay the account in installments and in this case a finance or service charge related to the unpaid balance of the account is added to the account each month. The buyer's regular payments are not specifically attributable to the purchase price of any single item but only go to reduce the unpaid balance on what may be the total purchase price of several items purchased at different times.

Despite these differences the U.S. district court in Massachusetts held revolving credit sales did qualify for installment sale treatment because, like installment sales they did retain the essential feature of an arrangement for the payment by the purchaser for the merchandise sold to him in a series of periodic payments of an agreed part or installment of the debt due (*Consolidated Dry Goods* v. *U.S.*, 180 F. Supp. 878; 1960). Shortly after this case was decided, the Internal Revenue Service announced that it would not follow the decision but was studying whether workable standards could be formulated for determining what part of revolving credit sales qualify as "sales on the installment plan" under existing law (Rev. Rul. 60-293, 1960-2 CB 163).

New regulations were issued by the Treasury Department on October 15, 1963 (TD 6682) as the result of this study. They specifically provide for installment sale treatment of some amounts received under revolving credit plans, and include rules for determining the extent to which revolving credit plans qualify as installment sales. Broadly speaking, under these rules, a sample of revolving credit sales is taken from balances in customer accounts as of the billing dates for the last month of the seller's taxable year, and the percentage of sales in the sample accounts determined which (1) are of the type the revolving credit plan contemplates will be paid for in two or more installments and (2) actually are paid for in two or more installments. This percentage is then applied to total revolving

sales accounts (after adjusting for sales of nonpersonal property) and the resulting amount is considered to be sales under the installment plan. This new regulation provides installment sale treatment for about 80 percent of revolving credit sales.

(*b*) *General reasons for provision.*—Your committee believes that although the new revolving credit regulations are commendable, they are difficult to apply. By providing in the statute that revolving credit sales are to qualify for income spreading, your committee's bill fully conforms the tax treatment of income under revolving credit plans and installment sales contracts. It also replaces the complex sampling procedure required by the regulations with a simple rule which will forestall compliance and administrative problems likely to arise under the regulations. It, of course, is not intended in making this change to exclude from installment sales treatment any sales or existing charges which are covered by existing law or regulations.

(*c*) *General explanation of provisions.*—This amendment adds definitions of two terms of the provision of present law which allows dealers in personal property to spread income from installment sales over the payout period under the installment contract. These terms are "installment plan" and "total contract price."

(*c*)(*i*) *Installment plan.*—The definition of "installment plan" would extend installment sale treatment to income received under any plan which provides for the payment by the purchaser for personal property sold to him in a series of periodic installments of an agreed part or installment of the debt due the seller. This definition would extend installment sale treatment to revolving credit sales of personal property which do not qualify under the new Treasury regulations. These include, principally, sales which are paid for in full on the first billing for the month of purchase, and sales for a month which in total amount to less than the monthly payment agreed to be paid by the purchaser under the revolving credit contract.

(*c*)(*ii*) *Total contract price.*—The proposed definition of "total contract price" would include finance and service charges with respect to revolving credit sales in the amount subject to installment sale treatment, thereby conforming to the treatment which is permitted in the case of the "time price differential" under traditional installment sale arrangements. Time price differentials are treated as part of the contract price and are not required to be included in income for tax purposes until the installments are received under the contract. Finance charges under revolving credit plans on the other hand, under the new regulation, may not be deferred until payments are received but must be accrued currently in the month to which they relate. The amendment does not change present law with respect to the treatment of amounts charged for service contracts or warranties.

(*c*)(*iii*) *Effective date.*—The amendments made by this provision are to apply with respect to taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—These amendments are expected to result in a revenue loss of $140 million in the first full year of operation. However, this is a nonrecurring loss which is not repeated in subsequent years. The loss thereafter is expected to be about $10 million a year.

28. *Timing of deductions and credits in certain cases where asserted liabilities are contested (sec. 224 of the bill and sec. 461 of the code)*

(*a*) *Present law.*—Prior to the decision in the *Consolidated Edison* case[1] the Internal Revenue Service generally held that the payment of a contested tax liability resulted in the tax being considered as deductible even though the tax was still being vigorously denied and contested.[2] In the *Consolidated Edison* case decided in 1961 the Supreme Court held that a contested tax even when paid does not accrue as a deduction for income tax purposes until the contest is terminated. It was held that the tax was not deductible until after the contest was settled because all of the events which would determine whether or not the amount would ultimately have to be paid would not be determined until that time.

(*b*) *General reasons for provision.*—Although your committee does not question the legal doctrine laid down by the Supreme Court in the *Consolidated Edison* case, it believes that it is unfortunate to deny taxpayers a deduction with respect to an item where the payment has actually been made, even though the liability is still being contested either as to amount or as to the item itself. The objective of the reporting of items of income and deduction under the internal revenue laws generally is to realistically and practically match receipts and disbursements attributable to specific taxable years. The internal revenue laws contain a number of adjustments designed to accomplish this result. Your committee believes that allowing the deduction of items in the year paid, even though they are still being contested in the courts or otherwise, more realistically matches these deductions up with the income to which they relate than would the postponement of the deduction, perhaps for several years, until the contest is settled. To the extent that deductions are allowed under this rule and then subsequently as a result of the contest the items were found not to be payable, adjustment can be made for this overstatement of the deduction by the inclusion of the overstatement in income in the year in which the amount of the liability is finally determined.

(*c*) *General explanation of provision.*—In view of the above considerations, your committee has amended the provision of existing law which specifies the year for the taking of deductions or credits generally. The amendment provides that if a taxpayer contests an asserted liability, such as a tax assessment, but makes a payment in satisfaction of this liability and the contest with respect to the liability exists after the payment, then the item involved is to be allowed as a deduction or credit in the year of the payment. This is based upon the assumption that the deduction or credit in this case would have been allowed in the year of payment, or perhaps in an earlier year when it would have been accrued, had there been no contest.

The treatment provided here can be illustrated by an example. Assume that in 1965 a $100 liability is asserted against a business which it pays at that time but contests the liability in a court action. Assume further that in 1967 the court action is settled for $80. Under present law, before the enactment of this provision, the deduction of $80 would be allowed in 1967. Under your committee's action, the taxpayer could claim a $100 deduction in 1965 but then in 1967 would

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[1] *The United States* v. *Consolidated Edison Co. of New York Inc.*, 366 U.S. 380 (1961).

[2] This is the general rule laid down in *Chestnut Securities Co.* v. *United States* (62 F. Supp. 574 (1945)) which the Internal Revenue Service accepted in GCM 25298 (1947-2 CB 39).

have to take $20 into income except as provided in section 111 of the code, relating to recovery of bad debts, prior taxes, and delinquency amounts.

In those cases where payment is not made until after the contest is settled, this does not prevent an accrual basis taxpayer from accruing the deduction or credit in an earlier year in which the contest is settled.

A similar amendment to that described above is also made to the Internal Revenue Code of 1939.

(*c*)(*i*) *Effective date.*—Generally, your committee's amendment to the 1954 code is to apply to payments made in taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the 1954 code. The amendment to the 1939 code applies to payments in taxable years to which that code applies.

The bill provides two exceptions to the general effective date rule specified above. First, if the taxpayer elects, he may continue to apply the old law with respect to taxable years beginning before January 1, 1964; i.e., he may claim the deduction or credit in the year in which the contest is settled rather than in the year in which the payment is made. If the taxpayer makes this election, he must do so within 1 year after the date of enactment of this bill and may not change this election after the expiration of this 1-year period. Moreover, to make this election the taxpayer must follow the rule of old law with respect to all payments made in a year beginning before January 1, 1964. This election may not be made with respect to a payment if the assessment of any deficiency arising as a result of this election would be barred with respect to any year. If this election is made with respect to a year which is not barred, the period for assessment of any deficiency arising from this election is to be kept open at least until 2 years after the date of enactment of this bill.

The second general exception to the general effective date is designed to keep a taxpayer from losing a deduction as a result of the enactment of this new provision. Thus, where for a past year no deduction or credit was allowed for a payment in a year before the contest with respect to it was settled and the refund or credit which would result from the deduction in the earlier year is barred, then the deduction is to be allowed in the year in which the contest is settled.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible decrease in revenues.

29. Interest on certain deferred payments (sec. 225 of the bill and sec. 483 of the code)

(*a*) *Present law.*—Under present law, an individual may sell a capital asset on the installment basis without making any specific provisions for interest payments on installments. In such cases the full difference between the cost or other basis for the property and the sales price usually is treated as capital gain to the seller. The buyer takes as a basis for the property the total sales price paid. For example, an individual taxpayer might sell a capital asset worth $1,000 for $1,300 payable over 10 years. In this case, if no mention is made that part of this payment is to be treated as interest, and the seller elects to report any gain on the installment basis, then each payment might be treated partly as a return of capital and partly as a capital gain. Over the 10-year period, the taxpayer would report $300 of

capital gain (assuming he had the full fair market value of $1,000 as his basis for the property). However, had $300 of this $1,300 payment been specified as an interest payment, this amount would have been ordinary income to the seller rather than capital gain. From the buyer's standpoint, the $300, if treated as part of the price of the property would be added to the basis of the property and, in the case of depreciable property be recoverable over the life of the property. He might also, if the property qualified, be eligible for an investment credit with respect to this $300. On the other hand, if this $300 were treated as interest, he could receive an interest deduction for this amount.

(*b*) *General reasons for provision.*—Your committee agrees with the House that there is no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments. This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments. In the case of depreciable property this may convert what is in reality ordinary interest income into capital gain to the seller. At the same time the purchaser can still recoup the amount as a deduction against ordinary income through depreciation deductions. Even where the property involved is a nondepreciable capital asset, the difference in tax bracket of the seller and buyer may make a distortion of the treatment of the payments advantageous from a tax standpoint. The House and your committee believe that manipulation of the tax laws in such a manner is undesirable and that corrective action is needed.

(*c*) *General explanation of provision.*—The bill solves the problem referred to above by providing that where property is sold on an installment basis and part or all of the payments are due more than 1 year after the date of the sale or exchange—if no interest payments are specified or if "too low" interest payments are specified then part of each payment due after 6 months is to be treated as interest rather than as part of the sales price.

The interest rate to be used for purposes of this provision is to be a rate provided by regulations prescribed by the Secretary of the Treasury or his delegate. It is anticipated that any rate specified by the Secretary of the Treasury or his delegate will reflect the going rate of interest and will not be higher than the rate at which a person, in reasonably sound financial circumstances and with adequate security could be expected to borrow money from a bank. A rate of 5 percent, for example, would appear appropriate under existing circumstances.

With this interest rate specified by the Secretary, the proportion of each payment which would be considered an interest payment would be determined in the following manner: First, the present value of each installment payment would be determined, based upon the specified interest rate. Second, the deduction of the total of these present values from the total actual payments provided for under the contract then would give the total "unstated" interest payments under the contract.[1] Third, the total unstated interest then is assumed

[1] Where an interest rate was provided on the installments but at "too low" a rate, the present value of these interest payments would be determined along with the present value of the remainder of the payments as well. The unstated interest then would represent the present values, including the present values of such interest payments, deducted from total payments to be received under the contract excluding the interest payments.

to be spread pro rata over the total payments involved. Thus, if a specific payment represents one-tenth of the total payments, it would be assumed to include one-tenth of the total unstated interest.

For ease of administration and compliance, the regulations are to provide for the discounting of payments on a 6-month basis and are to ignore for this purpose any interest payments due within the first 6 months.

Where an installment contract provides for the payment of some interest, no unstated interest is to be computed unless the interest payments specified are at a rate more than 1 percent below the rate of interest payments which would be computed under this provision in the absence of those payments. Thus, if a 5-percent rate is specified by the Secretary, no unstated interest will be computed where the interest actually provided for under the contract is 4 percent or more. This represents a de minimis rule to prevent the application of this provision in those cases where interest variations are relatively minor.

For purposes of this provision, a payment for property in the form of a note, or other evidence of indebtedness of the purchaser, is not to be treated as a payment. To treat such amounts as payments would permit avoidance of this provision merely by exchanging non-interest-bearing forms of indebtedness for property. However, payments made on such indebtedness for purposes of this provision will be treated as if they were payments made on the contract itself.

Where, at the time of the sale or exchange, some or all of the payments are indefinite as to their size; for example where the payments are in part at least dependent upon future income derived from the property, the "unstated" interest for purposes of this provision will be determined separately with respect to each indefinite payment as it is received, taking into account the time interval between the sale or exchange and the receipt of the payment. Also, where there is a change in the amount due under a contract, the "unstated" interest is to be recomputed at the time of each such change.

The bill specifies five situations in which this provision is not to apply: First, a de minimis rule as to price is provided. Thus, the provision will not apply unless the sale price of the property is in excess of $3,000. Second, in the case of the purchaser of the property, if any of the amounts involved are carrying charges which under present law from the standpoint of the purchaser are treated as interest, then, in the case of the purchaser, this provision is not to apply. Third, in the case of the seller, this provision is to apply only if some part of the gain from the sale or exchange of the property would be considered as gain from a capital asset or as gain from depreciable property. If the property is sold at a loss, this provision will nevertheless apply if, had there been a gain, some part of it would have been considered as gain from a capital asset or from depreciable property. Fourth, this provision is not to apply in the case of payments with respect to patents, which are treated as capital gain under present law. Fifth, the provision is not to apply where the property is exchanged for annuity payments which depend in whole or in part on the life expectancy of one or more individuals. In addition, this provision, of course, will not apply to payments such as those for timber, coal and iron ore (sec. 631) where the property is treated as sold as the timber is cut or the coal or iron ore is withdrawn, with the result that this is not treated as an installment contract.

(c)(i) *Effective date.*—Under the House bill this provision applies to payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963. Your committee has accepted the House effective date, but has provided one exception to it. It has provided that the new rule is not to apply to any sale or exchange made pursuant to a binding, written contract (including an irrevocable written option) entered into before July 1, 1963. This is consistent with the treatment provided elsewhere in the bill with respect to binding contracts.

(d) *Revenue effect.*—This provision is expected to result in a negligible increase in revenues.

30. Personal holding companies (sec. 226 of the bill and secs. 541–543 of the code)

(a) *Present law.*—Under present law, a domestic personal holding company is taxed on its "undistributed personal holding company income" at a rate of 75 percent on the first $2,000 and 85 percent on the balance. This is in addition to the regular corporate income tax. In general terms, a personal holding company is a closely held corporation, most of whose income is derived from certain specified forms of passive income. The tax applies only where 50 percent or more in value of the outstanding stock of the corporation is owned directly or indirectly by five or fewer individuals. In addition, at least 80 percent of the corporation's gross income must be from what is defined as "personal holding company income."

In general terms, personal holding company income consists of income from what are considered to be passive forms of investment. Thus, it includes dividends, interest, and annuities. It also includes most royalties although mineral, oil, or gas royalties are included only where these royalties do not represent 50 percent or more of the company's gross income or where there are not trade or business deductions (other than compensation for personal services rendered by shareholders) equal to 15 percent or more of the company's gross income. Copyright royalties also are classified as personal holding company income if they represent less than 50 percent of the company's gross income or the business deductions (other than compensation for personal services rendered by shareholders) represent less than 50 percent of gross income or if other personal holding company income constitutes more than 10 percent of gross income. Thus, where these mineral, oil, gas, or copyright royalties represent the principal business of the company, this type of income is not classified as personal holding company income, if there also is evidence, in the form of sufficient business deductions, that the company is actively engaged in business. Rents also are classified as personal holding company income unless they represent 50 percent or more of the company's gross income. Other forms of income which are classified as personal holding company income includes income from stock, security, and commodity transactions (except in the case of dealers, producers, etc.), income from estates and trusts, income from personal service contracts where 25 percent or more of the stock of the corporation is owned directly or indirectly by the individual performing the services, and income from the right to use property of the corporation where 25 percent or more of the stock of the corporation is owned directly or indirectly by the person eligible to use the property. This latter category of income, however, is treated as personal holding

company income only where 10 percent or more of its income (without regard to this latter category or rents) is personal holding company income.

(*b*) *General reasons for provisions.*—Congress first imposed this tax on personal holding companies in 1934 in order to prevent the avoidance of the individual upper bracket surtax rates, by leaving what is essentially investment-type income in a corporate organization, subject to the lower corporate income tax. As indicated by the Administration, ways around the present personal holding company provisions have been found in several arrangements which permit the use of holding companies to avoid the individual income tax with respect to what is essentially investment-type income without the company involved being classified as a "personal holding company."

The principal avoidance devices involve the use of rental income, income from mineral operations, and certain capital gains which are not classified as personal holding company income as means of sheltering other investment income in such a manner that 80 percent or more of the company's gross income does not come within the technical definition of personal holding company income. In view of this, a number of modifications are made in the personal holding company provisions designed primarily to minimize the extent to which these special categories of income can be used to shelter clearly passive income. More detailed reasons for each of the various modifications provided by the bill are set forth in the explanation given below with respect to each of the modifications.

(*c*) *General explanation of provisions.*—The bill makes a series of modifications in the application of the personal holding company tax in the case of domestic corporations. However, except in the case of the dividends paid deduction in a liquidation, no change is made in the case of foreign personal holding companies. Most of the modifications described below are designed to eliminate various means by which holding companies have been avoiding classification as personal holding companies, although other problems are also dealt with.

(*c*)(*i*) *Tax rate of 70 percent.*—In view of the fact that this bill decreases the maximum tax rate applicable to individuals from 91 to 70 percent, your committee agrees with the House that the rates applicable to personal holding companies also should be lowered from the present rates of 75 percent on the first $2,000, and 85 percent on the excess, to what will be the new top individual income tax rate. Moreover, there appears to be no particular purpose for continuing the graduation in the personal holding company tax rate from 75 percent on the first $2,000 to 85 percent on the balance. In view of this, the bill provides that the personal holding company tax is to be 70 percent of the undistributed personal holding company income.

(*c*)(*ii*) *Decrease in 80-percent test.*—As previously indicated, one of the tests under present law provides that a company, to be a personal holding company, must derive 80 percent or more of its gross income from certain specified types of passive income, called personal holding company income. The bill decreases this 80-percent test to 60 percent. The decrease in this percentage is made because too many holding companies which are essentially holding companies of passive income have avoided the classification as such by holding their "personal holding company income" just slightly below the 80-percent limit. The more realistic 60-percent limit together with

other modifications described below will make the avoidance of this classification much more difficult for holding companies generally.

(*c*)(*iii*) *Adjusted ordinary gross income requirement.*—Under present law the 80-percent requirement referred to above is applied to the gross income of the corporation; i.e., if the gross income derived from certain specified passive sources equals 80 percent of the total gross income of the corporation, the corporation is classed as a personal holding company. This has made it possible for corporations to avoid personal holding company classification by seeking out types of income not characterized as passive, or of a personal holding company type, which give rise to a proportionately large amount of gross income even though leaving little, if any, income after the deductions attributable to this income. In this manner, various types of income have been used to shelter investment income and remove the company from the classification of a personal holding company. Rents, where they constitute more than 50 percent of the gross income of the corporation, are an example of a type of income used to shelter passive income, such as dividends. Mineral, oil, and gas income are the other principal examples of income which have been so used.

To overcome this problem, the bill adjusts downward the income from certain sources to the extent of certain specified deductions attributable to these types of income. Thus, the corporation will be a personal holding company if 60 percent of "adjusted" gross income consists of certain passive income. The adjustments are as follows:

1. In the case of gross income from rents, the deductions for depreciation and amortization, property taxes, interest, and rents paid to the extent attributable to the rental income received, are to be deducted from gross income.
2. In the case of mineral oil, and gas royalties and also in the case of working interests in oil or gas wells, the deductions attributable to these royalties or working interests for depreciation, amortization and depletion, property and severance taxes, interests and rents paid are to be deducted in computing this adjusted gross income. It should be clearly understood that although income from working interests in an oil and gas well for purposes of the 60-percent limitation are reduced by the deductions referred to above such income is itself never classified as personal holding company income.
3. Interest from U.S. Government bonds held for sale by a dealer who is making a primary market for these obligations and interest on condemnation awards, judgments and tax refunds also are to be excluded in arriving at adjusted gross income for this purpose. This adjustment serves a different purpose from the first two deductions in that it merely excludes from the base on which personal holding company income is computed this particular type of interest income which in reality is not passive in nature.

In applying the 60-percent test, not only is the total gross income adjusted downward by the amount of the deductions (or interest) referred to in the cases specified above, but also in determining the rental income and mineral, oil and gas income for purposes of this test, this income also is reduced by the specified reductions.

(*c*)(*iv*) *Capital gains.*—Under present law capital gains (other than capital gains attributable to stock, securities, or commodities) are

not treated as personal holding company income. All capital gains, however, are included in the gross income of the company for purposes of the 80-percent test. As in the case of the deductions referred to above, some companies have timed the realization of their capital gains income in such a manner as to keep their personal holding company income below the 80 percent. The bill avoids this problem by excluding all capital gains from the gross income in determining whether the 60-percent test is met. Thus, the test under the bill is based on adjusted ordinary gross income.

(c)(v) *Rental income.*—Under present law rental income is classified as personal holding company income only if it represents less than 50 percent of total gross income. This is based on the concept that where rental income represents the major activity, the activity involved is more likely to be of an active rather than passive character. The House bill retains this 50-percent test (applying it, however, to adjusted income from rents and to adjusted ordinary gross income) but adds a second test providing that rental income may be characterized as passive, or personal holding company income even where it represents 50 percent or more of the adjusted ordinary gross income if, apart from the rental income, more than 10 percent of the ordinary gross income (gross income excluding capital gains) of the company is personal holding company income. For this purpose, income derived from the use of corporate property by shareholders is not viewed as personal holding company income, but income from copyright royalties and the adjusted income from mineral, oil, and gas royalties is included for this purpose as personal holding company income.

Your committee has accepted the House changes in the 50-percent test with one modification. Your committee has made an amendment to this test with regard to rentals of tangible personal property retained by the lessee for three years or less. Under the amendment, in the case of such property, the income is not to be reduced by depreciation attributable to it for purposes of the 50-percent test and also for purposes of computing ordinary gross income. However, in the case of the provision in the House bill that the personal holding company income (apart from rent) may not exceed 10 percent of the ordinary gross income, your committee's amendments provide that the personal holding company income for this purpose may be reduced by dividends paid during the year, by dividends paid in the next year which are treated as if paid in the year in question, and by consent dividends. Your committee believes that this prevents the 10-percent rule from working harshly where the personal holding company income other than rents may exceed 10 percent of ordinary gross income, perhaps by only a small amount but under the House bill, nevertheless, result in the entire amount of rental income being classified as personal holding company income. Your committee's amendment in effect permits taxpayers to meet the 10-percent test after dividend payments (or amounts treated as paid in dividends). At the same time it gives assurance that the personal holding company income (apart from rent) sheltered in the company may not exceed 10 percent of its ordinary gross income.

The fact that rental income, both in applying the 60-percent test and also in applying the 50-percent provision to the rental income itself, is determined on the basis of reducing rental income by depre-

ciation, amortization, property taxes, interest, and rents paid has already been noted above. However, as previously indicated, tangible personal property rented for three years or less is not reduced by depreciation attributable to it for purposes of these tests, under your committee's amendments.

(c)(*vi*) *Mineral, oil, and gas royalties.*—Under present law mineral, oil, and gas royalties are considered to be personal holding company income unless they represent 50 percent or more of the gross income of the company and unless the trade or business expense deductions (other than compensation for personal services rendered by shareholders) represent 15 percent or more of the gross income of the company. Thus, under present law, as in the case of rental income, mineral, oil, or gas royalties are treated as personal holding company income unless they represent the bulk of the company's income. However, in this case there also must be business expenses—indicating the active character of the business—constituting 15 percent or more of the gross income.

The bill retains these two tests but applies them on the basis of the adjusted ordinary gross income, thereby reducing, for this purpose, the income considered to be in these categories by depreciation, depletion, property and severance taxes, interest, and rent paid.

In addition, the bill adds another test which must be met in such cases for the mineral, oil, or gas royalty income to escape characterization as personal holding company income. The personal holding company income of the company, apart from this category of income (but including as such income that from copyright royalties and from rents), must not represent more than 10 percent of the ordinary gross income of the company. Thus, the personal holding company type income which mineral, oil, or gas royalty income may shelter even where this income represents the bulk of the income of the company must be relatively small; namely, less than 10 percent of ordinary gross income. Your committee has also added an amendment making it clear that income from mineral, oil, and gas royalties includes production payments and overriding royalties.

(c)(*vii*) *Copyright royalties.*—Under present law, copyright royalties also are considered to be personal holding company income unless they represent 50 percent or more of the total gross income. An additional test which must be met in order to escape such classification is that the personal holding company income, apart from the copyright royalty income, must not exceed 10 percent of the company's gross income and the trade or business expense deductions (other than those for compensation for personal services rendered by shareholders or for royalties paid to shareholders) must represent 50 percent or more of the company's gross income. This provision is modified by the bill in that the requirement that deductions equal at least 50 percent of gross income is changed to provide that they must equal 25 percent of ordinary gross income reduced by royalties paid and by depreciation deductions with respect to the copyrights.

(c)(*viii*) *Produced film rents.*—Under present law payments received from the distribution and exhibition of motion picture films are treated as rentals. As a result, under present law, a corporation may be formed by an individual who owns a motion picture negative and have its earnings treated as rents for purposes of the personal holding company tax. Since in such a case more than 50 percent of its gross

income would be considered to be from rents, there would be no personal holding company tax payable in this case.

To meet this problem, the bill provides that payments received from the use of, or the right to use, films generally will be characterized as copyright royalty income. Thus, such income will be classified as personal holding company income unless 50 percent or more of the company's ordinary income is from this source, not more than 10 percent of the company's ordinary gross income is personal holding company income, and the deductions properly allocable to this film income represent 25 percent or more of the gross income from this source reduced by royalties paid and depreciation taken.

The bill, however, retains what is essentially the treatment of present law for "produced film rents." Produced film rents are rents arising from an interest in a film acquired before the production of the film was substantially complete. It was thought that less severe tests should be applied in such cases because the participation in the production of the film in itself indicates an active business enterprise in this case. For produced film rent to escape characterization as personal holding company income, as under present law, these rents need constitute only 50 percent or more of the ordinary gross income of the company.

(c)(ix) Other types of income characterized as personal holding company income.—Compensation for the use of property by a shareholder, amounts received under a personal service contract, and income from estates and trusts continue to be classified as personal holding company income essentially to the same extent as under present law, except for the fact that capital gain income is not classified as part of gross income in applying the 10-percent test in the case of the use of corporate property by shareholders.

(c)(x) Personal finance companies.—Present law provides that certain types of companies are not to be classified as personal holding companies. These include, for example, banks, life insurance companies, and surety companies. Also excluded from such classification are certain types of personal finance companies. Under present law, there are four different types of personal finance companies which are excluded from the personal holding company category. These categories in general terms are as follows:

1. Licensed personal finance companies, 80 percent of whose gross income is interest from loans if at least 60 percent of their gross income is received from loans classified as "small loans" by State law (or $500 if there is no State law limit) and if the interest is not payable in advance and computed only on unpaid balances. In addition, loans to a person who is a 10-percent shareholder must not exceed $5,000 in principal amount. These frequently are known as "Russell Sage" type personal finance companies.

2. Other lending companies engaged in the small loan or consumer finance business, 80 percent of whose gross income consists of interest or similar charges on loans to individuals and income from 80-percent-owned subsidiaries which in turn themselves meet this test. In addition, at least 60 percent of the company's income must be from interest or similar charges made in accordance with small loan or consumer finance laws to individuals where the loans do not exceed the State specification for small

loans (or if there is no such limit, $1,500) and if the trade or business expenses of the company represent 15 percent or more of the company's gross income. These companies also must not have loans outstanding to shareholders, with a 10-percent interest or more, which exceed $5,000.

3. A loan or investment company (such as a Morris Plan bank), a substantial part of whose business consists of receiving funds not subject to check and evidenced by certificates of indebtedness or investment, and making loans and discounts. Here also loans to a person who is a 10-percent shareholder may not exceed $5,000 in principal amount.

4. A finance company actively engaged in purchasing or discounting accounts or notes receivable, or installment obligations, or in making loans secured by any of these or by tangible personal property, if at least 80 percent of its gross income is derived from such business. In addition, at least 60 percent of such a company's gross income must be derived from certain categories of income. These categories, in general, relate to business or factoring-type loans: such as purchasing or discounting accounts or notes receivable, or installment obligations arising out of the sale of goods or services by the borrower in his business; making loans for not more than 36 months to businesses where the amounts are secured by accounts or notes receivable or installment obligations of the type described above, or secured by warehouse receipts, bills of lading, inventories, chattel mortgages on property used in the borrower's trade or business, etc. In the case of these companies, the trade or business expense deductions must represent at least 15 percent of the gross income of the company, and loans to those who are 10-percent shareholders in such company must not exceed $5,000 in principal amount.

In the interest of simplification, the House substituted one exclusion for the four now provided these categories of lending or finance companies. At the same time, it saw no need for purposes of the personal holding company provision to restrict the type of loans which these companies could make. It was suggested that this was properly a matter of regulation by State law governing these lending or finance businesses and that in any event the personal holding provisions do not apply to widely held corporations. In these latter cases only State law governs the type of loans which can be made.

In view of these considerations the House bill substituted for all four of the categories described above, one definition of a lending or finance company which is to be excluded from personal holding company tax treatment. This definition provided is designed first to assure that 60 percent of the company's income is from the active, regular conduct of a lending or finance business, and second that its personal holding company income [1] plus interest from U.S. obligations as a dealer in these obligations is not more than 20 percent of the company's ordinary income. These two limitations, and the restriction described below relating to business expense deductions, are designed to give assurance that the company is actively engaged in the lending or finance business and that not more than 20 percent of its remaining income is personal holding company income.

[1] For this purpose personal holding company income is computed without regard to income from subsidiaries qualifying under this exemption as lending businesses, but including gross income from rents royalties, produced film rents, and compensation for use of corporate property by shareholders.

Your committee has modified the requirement that not more than 20 percent of the company's ordinary income may constitute personal holding company income. The House bill permits a company engaged in the small loan business to satisfy the 20-percent test by excluding income which it receives from subsidiaries in the lending or finance business. Your committee's bill would extend this treatment to finance companies. Finally, a technical amendment makes it clear that income received for furnishing services and facilities to a lending or finance company is not to be treated as personal holding company income to members of the same affiliated group which meet the requirement of the exemption for the lending and finance companies, whether they are exempt from the personal holding company tax under the same or another provision.

In addition to 60- and 20-percent tests, the company must have certain business deductions described below, which are directly attributable to its lending or finance business equal to 15 percent of the ordinary gross income up to $500,000 plus 5 percent of the ordinary gross income between $500,000 and $1 million. This provision gives further assurance, as evidenced by the deductions of the company, that it is actively engaged in the lending or finance business. A fourth limitation applicable under present law in the case of all of the categories of lending companies denies the right to make loans to persons who are 10-percent shareholders to the extent of more than $5,000 a year in principal amounts.

The lending or finance business for purposes of this provision is defined as including the business of making loans and purchasing or discounting accounts receivable, notes, or installment obligations receivable, notes or installment obligations. It does not include, however, the making of loans or purchasing or discounting accounts receivable, notes or installment obligations if the remaining period to maturity on the loan or paper exceeds 60 months. It also does not include the making of loans evidenced by indebtedness issued in a series under a trust indenture and in registered form or with interest coupons attached. Your committee has amended the definition of a lending or finance business to make it clear that this includes the income from rendering services or making facilities available to another member of the same affiliated group which is also in the lending or finance business. This is provided because as a matter of economical operations, one company frequently hires the necessary personnel, acquires the appropriate facilities, and in accordance with the requirements of banks, borrows all of the money for the group. Then all of the corporations in the group pay a service charge for these services to the company performing them.

Business deductions for purposes of the 15-percent or 5-percent test include only those trade or business expense deductions which are deductible only by reason of section 162 or section 404 (other than compensation for personal services rendered by shareholders or members of their family), and depreciation deductions and deductions for real property taxes to the extent that the property to which they relate is used in the regular conduct of the lending or finance business. Trade or business expense deductions which are allowable specifically under other sections, such as the deduction for interest expense which is also allowable under section 163, are not included for purposes of the 15-percent or 5-percent test.

(c)(xi) *Liquidating dividends.*—Under present law, the 75- or 85-percent tax (70 percent under the bill) on personal holding companies applies only to the undistributed personal holding company income. Thus, this tax is applied after dividend distributions are taken into account. Included among the amounts treated as dividends eligible for the dividends paid deduction are distributions in liquidation to the extent of the accumulated earnings and profits. As a result, in the year of the liquidation of a personal holding company there is no income subject to personal holding company tax for that year. Despite the fact that the distributions are treated as dividends to the personal holding company, its stockholders in that year receive this income and report it at capital gains rates.

Thus, under present law, a company which is a personal holding company may nevertheless avoid both the personal holding company tax and the ordinary income treatment to its shareholders with respect to the personal holding company income the year in which it liquidates.

A problem is also presented in the case of corporations where a subsidiary is liquidated and both the parent and the subsidiary corporation are personal holding companies. In such a case, if the earnings and profits of the subsidiary exceed its undistributable personal holding company income in the year of the liquidating distribution, the parent corporation may use the excess dividend paid deduction in computing its own dividend paid deduction, thereby reducing its own undistributed personal holding company income in the taxable year and also in the 2 succeeding taxable years.

The bill meets these problems by limiting the application of section 562(b) to companies other than personal holding companies or foreign personal holding companies. However, it is provided in section 316(b) that in the case of a complete liquidation of a personal holding company within a 24-month period after the adoption of the plan of liquidation, that the term "dividend" is to include any amounts distributed in this liquidation to other than corporate shareholders to the extent of its undistributed income (before any deductions for this amount) only if the corporation involved designates amounts as dividends (and so notifies the distributee). If the corporation does so designate the distributions as dividends the individuals receiving a liquidating distribution from the personal holding company must report the amount so distributed as a dividend in the year of receipt. The bill also provides that in the case of a foreign personal holding company, the amount included in a United States shareholder's income is not to be diminished by any liquidating distributions made during the year.

An amendment is also made to the code which provides in the case of corporate distributees that where a complete liquidation of a personal holding company occurs within 24 months after the adoption of the plan of liquidation, the distribution is to be treated as a dividend for purposes of the personal holding company tax only to the extent of the corporate distributee's share of the undistributed personal holding company income for the taxable year of the distribution. Thus, the dividends paid deduction is allowed to a personal holding company only to the extent of the undistributed income for the taxable year and with respect to noncorporate distributees, only if such distributees treat such distribution as a dividend.

(c)(xii) *One-month liquidations.*—Your committee agrees with the House that while the tightening of the personal holding company

provisions as indicated in the prior discussion is desirable, nevertheless, it would be unfortunate to apply these provisions without any alternatives being available, to companies which in the past have not been classified as personal holding companies but which as a result of the new provision will for the first time find themselves subject to personal holding company tax. Your committee agrees that it would be unfair to require such companies to pay personal holding company tax if they are willing to liquidate. Although it is understood that some of these companies are willing to liquidate, nevertheless, it would represent a hardship under existing law for them to do so. The hardship arises from the fact that if they liquidate under the provisions of section 331 of the code, not only would the earnings and profits of such corporations be taxed to the shareholders at capital gains rates but also any other appreciation which has occurred in the value of the assets would be so taxed to them. Such companies in the absence of the new personal holding company provisions would face no necessity of liquidating and therefore under these circumstances no tax would now be paid with respect to these unrealized increases in value. The House and your committee believed it was appropriate therefore to forego the tax at this time on unrealized appreciations in value but to collect the capital gains tax on the earnings and profits distributed.

The bill, to facilitate the liquidation of these companies, provides a special provision (in sec. 333) applicable in the case of companies which, for one of the two most recent taxable years ending before December 31, 1963, were not personal holding companies under existing law, but would have been in that year if the new law provided by this bill had been in effect at that time. In such cases, the bill provides that any distribution in liquidation made by the corporation to the extent of the earnings and profits accumulated prior to the time of the liquidation is to be taxed at capital gains rates and that any remaining gain is to be recognized only to the extent of assets which consist of money or of stock or securities acquired by the corporation after December 31, 1962.

To be eligible for the treatment described above, the liquidation of one of these corporations must occur before January 1, 1967, under your committee's amendments (or January 1, 1966, under the House bill). The treatment described above providing capital gains treatment with respect to earnings and profits is not to apply with respect to any earnings and profits to which the corporation involved succeeds after December 31, 1963, under your committee's amendments (August 1, 1963, under the House bill) as a result of any corporate reorganization or as a result of a liquidation of a subsidiary of that corporation (except earnings and profits which on December 31, 1963 (August 1, 1963, under the House bill) constituted the earnings and profits of one of the companies described above or which were earned by such a company).

In addition to liquidations occurring before January 1, 1967, the capital gains treatment for earnings and profits accumulated before 1967 and nonrecognition of gain with respect to any other gains to the extent with respect to assets acquired before 1963 (and assets other than stock and securities acquired thereafter) the bill also makes this special liquidation treatment apply to certain corporations which liquidate after 1966 (1965 under the House bill). To qualify for

this post-1966 liquidation treatment, as in the prior case the corporation involved must be one which in at least one of the two most recent taxable years ending before December 31, 1963, was not a personal holding company under present law but would have been had the provisions of this bill been in effect with respect to that year. To qualify for this special post-1966 liquidation treatment, the corporation involved must also have incurred indebtedness in the period from December 31, 1933, to December 31, 1963 (August 1, 1963, under House bill), which is still outstanding, or incurred indebtedness after December 31, 1963 (August 1, 1963, under the House bill), which merely replaced indebtedness incurred before that time. So that the necessary records will be kept, the corporation must notify the Secretary that it may wish to liquidate under these provisions. This notice must be given before January 1, 1968 (January 1, 1967, under the House bill).

Cases have been called to the attention of your committee where corporations have entered into commitments to use their incomes to pay off such debts and where as a result it is difficult, if not impossible, for them to liquidate before this indebtedness is paid off. For that reason, the bill makes the liquidation treatment described above (but only with respect to earnings and profits accumulated before 1967) apply if the corporation liquidates in the year in which it either does pay off the pre-December 31, 1963, indebtedness or could have, if it had devoted all of its earnings or profits after 1963 to this purpose. In addition, it must also devote to this purpose any deductions for depreciation, amortization, or depletion since the funds in this case remain in the corporation and can be used to retire indebtedness. Thus, the special liquidation treatment described here with respect to liquidations occurring after 1966 is available only during the period of time necessary for the corporation to retire outstanding indebtedness out of earnings and profits and depreciation allowances.

Your committee has added an amendment providing that where a corporation believes that it is one of these "would have been" corporations eligible for the special liquidation treatment under section 333, if it subsequently is determined that it did not qualify for this treatment, the liquidation will, nevertheless, be treated as occurring under section 333 unless in the election it was indicated that it was made under section 333 only on the assumption that the new treatment would be available. Where the shareholders indicate that they made the election on this assumption, section 331 will apply if other requirements for the use of this liquidation section had been complied with.

(*c*)(*xiii*) *Postponement of new personal holding company provisions for certain corporations.*—To encourage the liquidation of companies which are not now personal holding companies but would become so as a result of the new provisions, a provision is added by the bill to the effect that such companies, if they liquidate before January 1, 1966, will not be subjected to the new personal holding company provisions provided by this bill. They will, however, have available to them the special liquidation provisions described immediately above and will be subject to the rules specified in the prior heading with respect to the dividends paid deduction. In addition, this provision will not apply in the case of the liquidation of a subsidiary corporation under section 332 unless before the 91st day after the last distribution by the subsidiary the parent corporation also is liquidated and both of these events occur before January 1, 1966.

(*c*)(*xiv*) *Deduction for amortization of indebtedness.*—In 1934, when the personal holding company provision was first adopted, Congress provided that indebtedness incurred before 1934 by a company which subsequently became a personal holding company would receive a special debt amortization deduction in computing its personal holding company tax. It was provided that to the extent that this debt was paid off, or amounts were set aside to pay off this debt, the tax base for purposes of the personal holding company tax was to be reduced by the amount of the amortization payments. Thus, these amortization payments were treated for purposes of the personal holding tax as deductions in the same manner as dividend distributions to shareholders.

The bill adds a similar provision for indebtedness incurred after December 31, 1933, and before January 1, 1964 (August 1, 1963, under the House bill), in the case of corporations which were not personal holding companies in one of the 2 most recent taxable years ending before December 31, 1963, but would have been had the new personal holding company provision been in effect at that time.

Qualified indebtedness for purposes of this provision includes not only the debt outstanding before January 1, 1964 (August 1, 1963, under the House bill), but also debt which has replaced that outstanding before January 1, 1964 (if the special amortization deduction has not already been taken for the repayment of the old debt). Thus, short-term bank loans, for example, which are renewed at intervals will not be disqualified for purposes of this amortization deduction if the taxpayer elects not to deduct the payment of the prior loan. In addition to deductions for actual payments, deductions are also permitted for amounts (if reasonable) which are irrevocably set aside to pay off a debt which may be payable at some future date.

The deduction for indebtedness under this provision is to be reduced by any deduction which the company receives for depreciation, amortization, or depletion, and for any deduction (in computing undistributed personal holding company income) for net long-term capital gains. These deductions are disallowed since the funds represented by them can be used by the corporation to pay off indebtedness in the same manner as the earnings and profits of the corporation. Any of these deductions not used in 1 year are carried forward for this purpose and used in a subsequent year. A special provision provides that where depreciable or depletable property which would give rise to this cutback in the indebtedness provision is disposed of after December 31, 1963, then to the extent the basis of the property disposed of exceeds the indebtedness which was transferred at the time of the same disposition the qualified indebtedness for which a deduction may subsequently be taken is reduced.

(*c*)(*xv*) *Effective dates.*—Generally the personal holding company provisions are made effective with respect to taxable years beginning after December 31, 1963. The dividends paid deduction modification and the liquidation provision, however, are to apply to distributions made in taxable years of the distributing corporation beginning after December 31, 1963.

(*d*) *Revenue effect.*—It is estimated that the personal holding company provision will result in a revenue increase of $15 million a year in a full year of operation.

31. Treatment of property in the case of oil and gas wells (sec. 227 of the bill and sec. 614 of the code)

(*a*) *Present law.*—The percentage depletion deduction, in the case of oil and gas, is either 27½ percent, multiplied by the gross income from the "property" or, if less, 50 percent of the net income from the "property." As a result, what constitutes "property" is of considerable significance in determining the percentage depletion deduction available. To avoid any reduction in the 27½-percent deduction on gross income from the property, it frequently is desirable to combine wells having a high ratio of net income to gross income with those having a low ratio so that the 50 percent net income limitation will have little, or no, effect.

At one time each separate mineral deposit in a lease or fee acquisition was treated as a separate property. Subsequently, the administrative practice arose of permitting, at the taxpayer's option, the aggregation or combination of deposits in a single lease or acquisition (sometimes referred to as a single tract or parcel of land). In 1954, Congress permitted the aggregation of properties across lease lines so long as all the properties were in one "operating unit." This change was prompted by circumstances of the hard mineral industry but it also applied to the oil and gas industries as well. In 1958, Congress adopted detailed rules in the case of the hard minerals. In general these rules provided that operating mineral interests may be aggregated mine by mine and any number of mines may be aggregated so long as they are in a single operating unit. These rules, to the extent applicable to hard minerals remain in force. In the case of oil and gas, Congress in 1958 gave operators an option to use either the 1939 code "lease" rule or the 1954 code "operating unit" rule.

The law and the regulations in the case of the "operating unit" rule provide that it is not necessary for purposes of the aggregation that the separate operating mineral interests be included in a single tract or parcel of land, or in contiguous tracts or parcels of land, so long as the interests are a part of the same "operating unit." In defining the "operating unit," the regulations refer to operating mineral interests which are operated together for the purpose of producing minerals. With respect to each taxpayer what constitutes an "operating unit" must be determined on the basis of his own operations. The operating units may not be uniform in the various natural resources industries or in any one of the natural resource industries. Moreover, in the case of a particular taxpayer, business reasons may require the formation of operating units that vary in size and content. The term "operating unit" refers, however, to a producing unit and not an administrative or sales organization. Among the factors which indicate that mineral interests are operated together as a unit are—

(1) Common field or operating personnel;
(2) Common supply and maintenance facilities;
(3) Common processing or treatment plants; and
(4) Common storage facilities.

It is made clear that operating mineral interests which are geographically widespread may not be treated as parts of the same operating unit merely because a single set of accounting records, a single executive organization, or a single sales force is maintained by the taxpayer with respect to such interests or merely because the products of the interests are processed at the same treatment plant. Generally,

however, the determination of the taxpayer as to what constitutes an operating unit is to be accepted unless there is a clear and convincing basis for a change in such determination.

(*b*) *General reasons for provision.*—There have been two major objections to the operating unit rule adopted in 1954 as applied to oil and gas. First, it has been difficult to determine what an operating unit is and this is a continuous source of controversy between taxpayers and the Government. The problem arises from the fact that the term "operating unit" apparently has no generally understood meaning within the oil and gas industries. Basically, it is a tax concept having no real business substance.

Second, the operating unit rule has proved objectionable because it gives taxpayers an opportunity to increase their percentage depletion deduction merely by choosing the best combination of high and low cost properties for purposes of this aggregation rule. This opportunity, of course, is available only to those large enough to have many diverse property interests. It is possible under this rule to include some leases or tracts of land within a large area and to omit others even though the latter may be contiguous to some of the property included, while other property included in the aggregation may be many miles away. Taxpayers, in fact, are contending that the term "operating unit" covers operations over widespread geographical areas, including substantial portions of several States.

To remove this controversy and also to delete this opportunity for larger companies to maximize their percentage depletion deductions by unrealistic grouping of properties, the bill for the future eliminates the operating unit aggregation rule in the case of oil and gas properties. No inferences are to be drawn from this, however, as to what constitutes an operating unit or as to what could properly be aggregated with respect to the period of time before this change is made. In place of the operating unit rule taxpayers, as was true before 1954, will be able to maintain separate deposits as separate properties or can combine some or all deposits falling within a single lease or acquisition. They will not, however, be able to combine different leases or acquisitions, except in the case of properties which are in a unitization agreement. In these latter cases the owners of the property have in effect exchanged their separate interests in their leases for undivided interests in the whole, with the result that all interests of a taxpayer in the unit become one property.

(*c*) *General explanation of provision.*—The operating unit rule of existing law provides that if a taxpayer owns two or more separate operating mineral interests which constitute all or a part of an operating unit, he may form one aggregation and treat as one property any two or more of these interests, treating as separate properties any interests which he does not include in this one aggregation. Separate operating mineral interests may be aggregated for this purpose whether or not they are in a single tract or parcel of land, or contiguous tracts or parcels. A taxpayer may not, however, form more than one aggregation within a single operating unit.

The bill repeals the rule described above for taxable years beginning after December 31, 1963, with respect to oil and gas. It substitutes in its place a rule which, in effect, restores the pre-1954 administrative practice. No longer will the aggregation of properties be permitted at the "operating unit" level. Except in the case of unitization agree-

ments discussed below, taxpayers may not aggregate oil and gas properties above the level of a separate lease or acquisition, or "separate tract or parcel of land" as referred to in the bill.

The general rule which will apply in the future is that all of the taxpayer's operating mineral interests in a separate lease or acquisition will be combined and treated as one property. However, the taxpayer may elect to treat separately operating mineral interests within a single lease or acquisition. Where he does this he may have either no combination, or one combination of mineral interests in that tract or parcel of land. If he has one combination, all other mineral interests not in that combination are treated as separate properties.

Where the taxpayer has elected to treat separately some or all of the operating mineral interests in a single lease or acquisition, and subsequently finds or acquires new interests in that property, the new interests, unless he elects otherwise, are to be treated as a part of the combination, if there is a combination, or as separate properties if there is no such combination.

The election to treat part or all of the operating mineral interests in a lease or acquisition as separate properties must be made at the time of the filing of the return for the first taxable year beginning after December 31, 1963, or if later, the first taxable year in which an expenditure for the development or operation of the operating mineral interest is made by the taxpayer after acquisition.

(*c*)(*i*) *Unitization or pooling arrangements.*—As previously indicated, a unitization or pooling agreement is to be an exception to the rule stated above. A unitization agreement arises where two or more taxpayers holding interests in separate tracts or parcels of land exchange their interests for an undivided interest in a larger area (either by formal conveyances or contractual arrangement). Such an agreement also arises where a taxpayer holding operating mineral interests in several leases enters into an arrangement to pay the lessors royalties based on an undivided share of the oil and gas from all the leases. The bill provides that in these cases all of the operating mineral interests of a taxpayer which participate in one of these unitization agreements are to be treated as a single property without regard to the rules specified above. This treatment applies to all compulsory unitization agreements required by State law and also to voluntary agreements which meet both of the following two tests:

(1) The operating mineral interests must be in the same deposit or two or more deposits, the joint development or production of which is logical from the standpoint of geology, convenience, economy, or conservation; and

(2) The operating mineral interests covered by the agreement must be in tracts or parcels of land which are either contiguous or in close proximity.

In making this determination under No. (1), tax benefits are not to be taken into account.

A special rule is provided in the case of unitization agreements entered into in taxable years beginning before January 1, 1964. In these cases, where for the last taxable year beginning before 1964 the taxpayer treated each interest as a separate property and if it is determined by law that this was the proper treatment, then the taxpayer may, if he so desires, continue to treat these interests as separate

properties despite the fact that they are in a unitization agreement.

(c)(ii) *"Unscrambling" of basis.*—In the past, because of the "operating unit" rule, taxpayers have aggregated two or more separate leases or acquisitions which under the new rules provided by this bill, they must treat separately. This means that any basis for these properties must be segregated or "unscrambled." In the great majority of the cases, it is understood that this will present no problem because of the fact that the entire basis of the property involved has already been written off by percentage depletion deductions. However, for those where some basis still remains, the bill provides two rules, either of which may be followed in "unscrambling" the basis of the operating mineral interests which for the future must be treated as separate properties. The first of these rules provides that any basis may be divided among the separate properties in accordance with the fair market value of each property. The second rule provides that taxpayers may take the adjusted basis of each property at the time it was first included in an aggregation and adjust this basis downward for adjustments reasonably attributable to the property so that the total of these adjusted bases equals the adjusted basis of the former aggregation.

(c)(iii) *Effective date.*—The amendments made by this provision apply to taxable years beginning after December 31, 1963. This does not involve any change in elections for those already covered under the 1939 code rules (sec. 614(d)).

(d) *Revenue effect.*—It is expected that this provision will result in an annual increase of revenue of $40 million.

32. Treatment of iron ore royalties (sec. 228 of the bill and secs. 631(c), 1231(b), and 272 of the code)

(a) *Present law.*—Under present law, iron ore royalties give rise to ordinary income; against this, however, a depletion deduction of 15 percent may be taken.

In the case of coal royalties, however, where the property has been held over 6 months, present law provides that the excess of the amount realized from the disposal of the coal, over the adjusted depletion basis and the expenditures attributable to making and administering the contract and in preserving the economic interest retained in the contract, is to be treated as a capital gain. Where capital gain is realized from coal royalties, no deduction is allowed for percentage depletion or generally for the making and administering of the contract or the preservation of the economic interest in the contract.[1]

(b) *General reasons for provision.*—Your committee agrees with the House that the tax treatment now available with respect to coal royalties also should be extended to iron ore royalties as well. The capital gains treatment was made available in the case of coal royalties in part at least to encourage leasing, and therefore production, at a time when the coal industry was facing strong competition from other forms of fuel energy. Today, domestic iron ore production also

[1] Where the expenditures referred to above plus the adjusted depletion basis of the coal disposed of exceed the amount realized under the contract and are not used to offset other gains, a loss is allowed (if some income is realized under the contract).

generally is decreasing. In recent years, for example, iron ore production in the United States has been as follows:

	Thousands of long tons
1950	98, 045
1955	103, 003
1958	67, 709
1959	60, 276
1960	88, 784
1961	71, 329

Source: Department of Interior, Bureau of Mines, Minerals Yearbook.

The capital gains treatment provided by this bill should encourage domestic leasing of iron ore properties to operators, and therefore should improve the position of domestic iron ore production relative to foreign production.

Your committee has modified the House bill, however, to limit the capital gains treatment for iron ore royalties to domestic iron ore. In addition, it has denied capital gains treatment for these royalties where the person receiving the royalty and the person acquiring the iron ore are related persons or are owned or controlled directly or indirectly by the same interests.

(c) *General explanation of provision.*—The bill provides that, as in the case of the disposal of coal, where iron ore is disposed of after being held for more than 6 months by the owner under a contract in which the owner retains an economic interest in the iron ore, the difference beween the amount realized from the sale of the iron ore and certain costs is to be treated as a capital gain. An amendment made by your committee limits this treatment in the case of iron ore to that mined in the United States.

The costs taken into account for purposes of determining the gain are the cost of the property itself (adjusted downward for any depletion deduction taken) plus expenditures in the taxable year for making and administering the contract and the preservation of the economic interest retained under the contract. However, where these expenditures together with the adjusted basis of the property exceed the amount realized under the contract and are not used to offset other gains from the sale or exchange of "property used in the trade or business," a loss is to be recognized. Thus, the costs and expenses incurred by the taxpayer are to decrease the amount received in determining the amount treated as a capital gain.

The bill treats these iron ore royalties like coal royalties as "property used in the trade or business." As a result, if the gains from iron ore royalties plus the gains from other "property used in the trade or business" exceed the losses from the same type of property, the gain is to be treated as capital gain.

In obtaining this capital gains treatment for the iron ore royalty the lessor must forgo any depletion deduction with respect to his property (although his adjusted depletion basis is taken into account in computing his gain). In addition, he must generally forgo any deductions for expenditures attributable to the making and administering of the royalty contract and any expenditures attributable to the preservation of his economic interest in this contract. The primary exception to the denial of the deductions in this case is where these expenses plus the adjusted depletion basis for the iron ore disposed of

exceed the royalty payments received and are not offset against other gains. With respect to this excess, a loss is allowed.

The House bill provided in the case of iron ore, as in the case of coal under present law, that the capital gains treatment is not to apply to income realized by any owner as a coadventurer, partner, or principal in the mining of the coal or iron. The word "owner" here means any person who owns an economic interest in the coal or iron ore in place including a sublessor. Your committee has added an amendment which in the case of iron ore further restricts the availability of the capital gains treatment. Under your committee's amendment, the capital gains treatment will not be available where the owner of the interest in the iron ore and the operator are related, or where the two parties are owned or controlled directly or indirectly by the same interests. "Relationship" here is the same as the relationship which would result in the denial of a deduction for losses in the case of the sale of property under section 267 or 707(b).

The iron ore for this purpose is considered as being sold on the date the iron ore is mined.

(c)(i) Effective date.—As amended by your committee, the capital gains treatment provided by this provision is to apply to amounts received or accrued in taxable years beginning after December 31, 1963, attributable to iron ore mined in taxable years beginning after December 31, 1963. In the House bill, the capital gains treatment would have applied to all iron ore mined in taxable years beginning after December 31, 1963, even though amounts were received with respect to such iron ore in prior taxable years.

(d) Revenue effect.—This provision is expected to result in an annual loss of revenue of $5 million.

33. Insurance companies; mutualization distributions made in 1962 (sec. 229(a) of the bill and secs. 809(d)(11) and 809(g)(3) of the code)

(a) Present law.—The Life Insurance Company Income Tax Act of 1959 provided a special rule where a stock life insurance company is "mutualized," or converted into a mutual life insurance company, with a liquidating distribution being made to the shareholders and the remainder of the surplus and reserves being held for the benefit of policyholders in what then becomes a mutual company.

The 1959 act provided a special deduction for these liquidating payments to shareholders. To the extent of the excess of any gain from operations for the year in question over the taxable investment income, a deduction is allowed in computing the phase 2 tax of the insurance company for amounts paid out in one of these liquidating distributions to the shareholders. The distribution has to be under a mutualization plan adopted before January 1, 1958. This deduction in computing the phase 2 tax cannot result in any lower tax than if the 1957 law had applied in the year in question. In addition, this amount is treated as paid first out of capital and paid-in surplus, to the extent of this capital and paid-in surplus, with the result that no tax is likely to arise under phase 3 of the life insurance company tax in the case of these distributions.

The treatment described here was initially made available with respect to distributions in 1958 and 1959 but was subsequently (in Public Law 87–59) extended to cover distributions in 1960 and 1961.

(b) General reasons for the provision.—The attention of your com-

mittee has been called to a case where a mutualization agreement was entered into before January 1, 1958, and the final distribution payment was authorized in 1961 but the distribution of these payments could not actually be made until 1962 because of the requirements of the State law involved. Your committee believes that liquidation payments made under these circumstances should be treated in the same manner as in the case of the mutualization liquidating payments made in prior years.

(c) *General explanation of provision.*—For the reasons given above, your committee has added an amendment to the bill providing that the special liquidating distributions rules provided by present law for the years 1958–61 under a mutualization agreement entered into before 1958 are also to apply to distributions in 1962. This will enable the company to receive a deduction for this amount (subject to applicable limitations) in computing its phase 2 tax and also to treat this amount for purposes of phase 3 as being made first out of capital and paid-in surplus, to the extent of such amounts, and only after that, is a part of this amount to be treated as a payment first out of the already tax-paid shareholders surplus account, to the extent of the balance of this account, and only then from the policyholders surplus account, withdrawals from which are subject to tax.

(c)(i) *Effective date.*—The amendment made by this provision is to apply to taxable years beginning after December 31, 1961.

(d) *Revenue effect.*—It is estimated that this provision will result in a negligible loss of revenue for 1 year.

34. Accrual of bond discount by certain insurance companies (sec. 229(b) of the bill and sec. 818(b) and sec. 822(d)(2) of the code)

(a) *Present law.*—Under existing law, prior to Rev. Rul. 60–210 (1960–1 CB 38), mutual fire and casualty insurance companies and life insurance companies amortized premiums and accrued discount on bonds purchased by them. In the case of State and local government bonds, these companies increased the amount of their deduction for tax-exempt interest by the amount of discount accrued by them. This had the effect of treating discount in the same manner as tax-exempt interest, without regard to whether the discount was on the original issue of the bond or whether it grew out of subsequent fluctuations in the market value of the bond.

Revenue ruling 60–210, issued May 31, 1960, draws a sharp distinction in tax treatment between "issue" discount and so-called "market" discount on State and local government bonds. Under this revenue ruling, in the case of issue discount, such discount continues to be treated as in the nature of tax-exempt interest, and the deduction for such interest continues to be increased by the amount of issue discount accrued each year. Market discount, on the other hand, although required to be accrued by these companies, no longer is allowed by the Internal Revenue Service to increase the deduction for tax-exempt interest. Thus market discount accrued by life insurance companies and by mutual fire and casualty insurance companies is taxed as ordinary income.

Stock fire and casualty insurance companies on the other hand, and corporations generally, are not required to accrue discount (either that arising at the time of issue or market) on bonds purchased at a discount by them. Rather these corporations treat market discount on both taxable and nontaxable bonds as capital gain (or loss)

when the bond is sold or disposed of by them and treat original issue discount on taxable bonds as ordinary income when it is realized.

The Revenue Act of 1962 further affected the tax treatment of discount on bonds purchased by mutual fire and casualty insurance companies (but not life insurance companies). Broadly speaking, it was the purpose of that act to treat mutual fire and casualty insurance companies more nearly like stock fire and casualty insurance companies for Federal income tax purposes. To accomplish this objective, mutual companies were taxed under a modified total income formula, which in effect converts accrued discount on bonds into an underwriting deduction. This effectively takes market discount out of the ordinary income tax base of these mutual companies and provides capital gain (or loss) treatment for market discount on both taxable and nontaxable bonds when the bonds are sold or disposed of by the mutual companies and treats original issue discount on taxable bonds as ordinary income as it is realized upon disposition. This treatment is identical to the treatment of discount by stock fire and casualty companies and other corporations. However, this treatment under the 1962 Revenue Act does not apply to all mutual fire and casualty insurance companies. Actually, it applies only to those companies which are subject to the modified total income tax.

Therefore, small mutual companies (those whose gross investment income, plus premiums, is between $150,000 and $500,000) which are taxed only on their investment profits must continue to treat accrued discount currently as ordinary income. In addition, life insurance companies must treat this discount currently as ordinary income.

(*b*) *General reasons for provisions.*—Your committee sees no reason for treating market discount on bonds owned by life insurance companies and by small mutual fire and casualty insurance companies as ordinary income when all other corporations, including all other insurance companies, are allowed capital gain treatment for such discount. Moreover, when the tax treatment of bond discount varies depending upon the type of business the bondholder may be engaged in, it is difficult for the bond market (particularly in the case of State or local government securities) to function normally, since the after-tax earnings on the bond will not be uniform.

Moreover, your committee desires to bring stability to an area of the tax law that has been unsettled since 1960. From 1942 until 1960 there was little question but that discount on tax-exempt bonds held by life insurance and mutual fire and casualty insurance companies, regardless of the source of the discount, was tax exempt. In 1960, however, the market portion of discount on such bonds was held by the Internal Revenue Service to be taxable as ordinary income. In 1962 larger mutual fire and casualty insurance companies (but not the smaller mutual fire and casualty companies and not life insurance companies) were provided capital gains treatment on their market discount. Under your committee's bill in the future, market discount on bonds held by insurance companies and other corporations will be taxed alike; that is, as capital gain when the bond is sold or redeemed.

(*c*) *General explanation of provision.*—This amendment provides that for taxable years beginning after December 31, 1962, market discount received by any insurance company will be taxed as a capital gain. This conforms the treatment of this discount in the case of

life insurance companies and small mutual fire and casualty companies with that presently accorded stock fire and casualty companies, and the larger mutual fire and casualty companies (under the Revenue Act of 1962) and corporations generally.

In the case of original issue discount, the amendment conforms the treatment by small mutual fire and casualty companies with the treatment of original issue discount received by stock fire and casualty, and larger mutual fire and casualty companies (under the Revenue Act of 1962). Under the amendment, this discount will be reported as ordinary income when it is realized upon disposition.

Life insurance companies, however, would continue (as under present law) to accrue original issue discount currently on both taxable and tax-exempt bonds.

(c)(i) *Effective date.*—The amendments made by this provision are to apply to taxable years beginning after December 31, 1962.

(d) *Revenue effect.*—This provision is expected to result in a negligible loss in revenue.

35. Contributions by certain insurance companies to qualified pension, etc., plans (sec. 229(c) of the bill and sec. 832(c)(10) of the code)

Under the Internal Revenue Code of 1939, deductions for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan were allowed under the same section (sec. 23(p)) as most other deductions from gross income. In the rearrangement made in the 1954 Code, however, the deduction for these contributions was transferred over to the subchapter relating to deferred compensation and pension, profit sharing, stock bonus plans, etc. However, the 1954 Code in the case of casualty insurance companies in providing for trade or business deductions, refers to deductions in part VI of subchapter B, relating to itemized deductions for individuals and corporations, unintentionally omitting the reference to section 404 wherein the deductions for contributions to qualified pension, etc., plans is provided under the 1954 Code.

To remove this clerical error in the 1954 Code, and to make it clear that deductions are allowed for contributions to a qualified pension, etc., trust in the case of these casualty insurance companies, your committee has added a provision to the bill containing an appropriate cross-reference to obtain this result. Thus, section 832(c)(10) of the code is amended by making specific reference to section 404 and following, which are the provisions relating to pension, profit sharing, stock bonus plans, etc.

The amendment made by this provision is to apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

36. Regulated investment companies: Time for mailing certain notices to shareholders (sec. 230(a) of the bill and secs. 852–855 of the code)

(a) *Present law.*—Under present law, companies may qualify as "regulated investment companies" if they meet certain tests set forth in the statute. In general, to qualify for this status, the bulk of a company's income must be derived from dividends, interest, and gains on the sale of stock or securities. In addition, to receive this treatment, a substantial portion of the company's assets must be in diversified stock investments rather than being concentrated in the stock of a single or a few companies. Where a company qualifies as a regulated

investment company, if it distributes at least 90 percent of its investment company income (excluding net long-term capital gains), then the company is taxed only on its undistributed income.

In addition, certain features of the tax law which generally would be applicable only to the company receiving the income, in the case of a "regulated investment company" may be passed through to its shareholders. In each of these cases, the present provisions of the Internal Revenue Code provide that the shareholder must be given notice with respect to these special tax features within 30 days after the close of the regulated investment company's taxable year.

(*b*) *General reasons for provision.*—This provision increases from 30 to 45 days after the close of a regulated investment company's taxable year the time accorded it for giving notices to its shareholders with respect to these special tax features. Your committee believes that the allowance of this additional 15-day period is desirable because the regulated investment companies have had difficulties in getting out their notices within the 30-day period. Moreover, since individuals generally are not required to file their individual income tax returns until the 15th day of the 4th month (rather than the 15th day of the 3d month of the year as at one time was the case) provision of this additional time for the regulated investment companies to submit these reports to their shareholders still leaves the shareholders with 2 months after the receipt of the notices before their tax returns need to be filed.

(*c*) *General explanation of provision.*—The various tax features with respect to which the regulated investment company under this bill is to be given 45 rather than 30 days after the end of the year for notice to its shareholders are as follows:

1. Under present law, dividends paid to shareholders of a regulated investment company may be designated as capital gain dividends to the extent of the excess of the net long-term capital gain of the regulated investment company over its net short-term capital loss (but only to the extent these amounts are paid out). In the case of these dividends, the company pays no tax but the shareholder includes the dividend in his income as a long-term capital gain. In this case, the company is to have until 45 days after the end of its taxable year to notify its shareholders as to the amount of the dividend (sec. 852(b)(3)(C)).

2. As an alternative to actually distributing net long term capital gains, a regulated investment company can report such capital gains and pay a 25-percent tax on this income. Then the shareholder may include his share of these capital gains in his income as long term capital gain and claim a tax credit for the tax paid by the regulated investment company. For this treatment to be available, the company must designate within 30 days after the close of the taxable year the amount to be so treated by each shareholder. This provision increases this period of time to 45 days (sec. 852(b)(3)(D)(i)).

3. Present law provides that where more than 50 percent of the value of a regulated investment company's assets consist of stock or securities in foreign corporations and certain other tests are met, then the regulated investment company may elect to treat as distributed to its shareholders any income, war profits, and excess profits taxes paid by it to a foreign country (or a possession of the United States). Where the company so elects, the shareholders of the company include the amount of these foreign (or possession) taxes in their income and

then either claim a deduction or foreign tax credit for these amounts. For this treatment to be available, notice must be mailed to the shareholders not later than 30 days after the close of the company's taxable year. The provision changes this 30-day period ~~to a~~ 45-day period (sec. 853(c)).

4. Existing law provides that where less than 75 percent of a regulated investment company's gross income represents dividend income, then the shareholder receiving a dividend from the regulated investment company is to treat the amount he receives as a dividend only in the ratio which the company's dividend income represents of its total gross income. Present law provides that a regulated investment company must supply its shareholders with written notices indicating how much of its income in these cases is to be treated as dividends. This written notice must be supplied the shareholder within 30 days of the close of the company's taxable year. This provision changes the 30-day period to a 45-day period (sec. 854(b)(2)).

5. Existing law provides that income may be treated as paid out in the year earned if a regulated investment company declares a dividend before the time specified by law for filing of its return for the year in question and distributes this dividend to its shareholders not later than at the time of the first regular dividend payment after the declaration. (The shareholder in such cases may take the income into account in the taxable year in which he receives the distribution.) For the dividends to be considered as paid out in the earlier year, notice under existing law with respect to such dividends must be made to the shareholders not later than 30 days after the close of the taxable year in which the distribution of the dividends is made. This provision changes the 30-day period to a 45-day period (sec. 855(c)).

(*c*) (*i*) *Effective date.*—The changes in the filing dates referred to above are to apply to taxable years of regulated investment companies ending on or after the date of enactment of this bill.

(*d*) *Revenue effect.*—It is expected that this provision will have no effect on revenues.

37. Regulated investment companies: Redemptions by unit investment trusts (sec. 230(b) of the bill and sec. 852(d) of the code)

(*a*) *Present law.*—Present law provides that mutual funds are to be treated for Federal income tax purposes as "regulated investment companies." To qualify for this treatment the corporations involved must have widely diversified investments largely consisting of stocks or bonds. Ninety percent or more of their ordinary income must also be paid out to their shareholders. Such corporations, however, pay tax on their net long term capital gain to the extent such capital gain is not distributed to the shareholders.

In some cases what are sometimes called unit investment trusts are also associated with a mutual fund. These unit investment trusts receive periodic payments from individuals and invest these funds usually in the stock of a single mutual fund. Under present law these unit investment trusts are themselves also classified as regulated investment companies.

(*b*) *General reasons for provision.*—A problem has arisen under present law where one investor liquidates his interest in one of these unit investment trusts. In such a case if the trust sells stock which it holds to make the liquidating distribution and the proceeds from the

sale are distributed to one investor it is possible to argue that the distribution is a "preferential dividend" (as defined in sec. 562(c)) and that for this reason it does not result in a dividends paid deduction for this amount to the trust (but only to the extent of the investor's allocable share of the gain). This would therefore result in a tax on the capital gain to the trust although it retained none of the capital gain in its possession.

(*c*) *General explanation of provision.*—To meet the problem described the bill provides that in the case of a redemption by the trust of the investor's stock (in whole or in part) the redemption will not be considered as preferential dividend. This amendment is not intended to have any effect on the law prior to the effective date of this provision.

(*c*)(*i*) *Effective date.*—This amendment applies to taxable years of regulated investment companies ending after December 31, 1963.

(*d*) *Revenue effect.*—It is expected that this provision will have a negligible effect on revenues.

38. Foreign tax credit with respect to certain foreign mineral income (sec. 231 of the bill and sec. 901(d) of the code)

(*a*) *Present law.*—Under present law, citizens of the United States and domestic corporations may treat foreign income, war profits, and excess profits taxes paid or accrued to a foreign country as a credit against their U.S. income tax otherwise payable. In addition to taxes paid directly by a U.S. taxpayer, domestic corporations are allowed a credit for foreign taxes paid by 10-percent-owned first tier foreign subsidiaries and by second tier foreign subsidiaries if 50 percent of their voting stock is owned by a 10-percent-owned first tier foreign subsidiary. Similar tax credits are allowed if so-called "tax haven" income is included in the gross income of a domestic corporate shareholder (under sec. 951).

Foreign taxes which may be allowed as a credit against U.S. tax are limited to the same proportion of the U.S. tax against which the credit is taken as the income from sources within each foreign country (the "per country" limitation), or alternatively all foreign countries (the "overall" limitation), bears to the entire taxable income of the taxpayer. Thus, if foreign tax on foreign source income of the taxpayer on a per-country or overall basis is equal to, or less than, the U.S. tax resulting from including the foreign source income in taxable income, the entire foreign tax is allowed as a credit. Except in the case of interest income which is not related to the taxpayer's foreign operations, computations of foreign and U.S. taxes on foreign source income, for purposes of the limitation on the foreign tax credit, are made without regard to the type of activity from which the income is derived. To the extent the foreign taxes on foreign source income exceed the U.S. income tax applicable to the same income, the excess foreign tax may be carried back 2 years and forward 5 years and be used as a credit against U.S. tax in those years to the extent the foreign tax credit limitation for these years exceeds the foreign tax credit otherwise allowable.

(*b*) *General reasons for provision.*—Under present law, U.S. taxpayers who extract minerals in foreign countries are allowed a deduction for percentage depletion in computing their U.S. income tax. Because of the allowance by the United States of percentage depletion to the mineral-producing industries, the U.S. tax payable on these operations is often lower than the foreign tax payable on the income

from the same operations. Although the rates of tax generally in the foreign country in which the mineral is extracted are not likely to be higher than ours, the fact is that they frequently do not allow a deduction for percentage depletion or grant it at a lesser rate than does the United States. To the extent foreign tax paid or accrued on foreign income derived from the extraction of minerals from mines, wells, or other natural deposits exceeds the U.S. tax on the same income, the excess foreign tax, under present provisions relating to the allowance of foreign tax credits, is available as a credit against U.S. tax otherwise payable on foreign source income from unrelated activities of the taxpayer in the same or other foreign countries.

To prevent continuance of this benefit, which is available only to U.S. taxpayers who are engaged in the business of operating foreign mines, wells, and other natural deposits, your committee has provided that excess foreign tax credits which are attributable to the allowance of percentage, rather than cost, depletion by the United States shall not be allowed as a tax credit against U.S. tax otherwise payable on the income from taxpayer's nonmineral foreign activities. For this purpose, however, the taxpayer's mineral income is to include income from refining, distribution, and retail sales of the mineral products as well as their extraction. This is set forth in more detail below. Treating these related activities in this manner is necessary to enable these companies to maintain their present competitive position with others engaged in mineral extraction abroad. On the other hand, however, since the foreign tax credit cannot offset income from domestic sources, this will have no effect on domestic production.

(c) *General explanation of provision.*—For purposes of computing foreign tax credits available to a U.S. citizen or domestic corporation who claims a deduction for percentage depletion, your committee's bill requires a taxpayer to divide his income into two parts: first, "mineral income" from sources without the United States, and second, income from all other sources.

For purposes of this provision, the bill defines "mineral income" as income derived from the extraction of minerals from mines, wells, or other natural deposits, income from the processing of such minerals into their primary products, and income from the transportation, distribution, and sale of the primary products derived from the mineral or of the mineral itself. Thus, for example, an integrated oil company would treat its entire income from the production of oil, income attributable to the refining of crude oil into gasoline, income from the distribution of gasoline to marketing outlets, and its income from retail sales of gasoline as mineral income. Similarly, income from the refining, distribution, and marketing of fuel oil by the taxpayer would also be treated as mineral income for this purpose, whether or not the oil sold was extracted by the taxpayer. However, income attributable to the manufacture, distribution, and marketing of petrochemicals is not to be treated as mineral income since your committee does not consider them to be primary products of oil. In addition to treating certain operating income as mineral income, taxpayers are permitted to treat dividends from corporations in which they own 5 percent or more of the voting stock as mineral income to the extent the dividend is attributable to mineral activities of the payor corporation. However, this rule only applies if the dividend is treated as income from sources without the United States for income tax purposes. Thus, for example, if a domestic oil company receives

a dividend from a foreign oil pipeline company in which it owns more than 5 percent of the voting stock at the time of the distribution, the domestic company may treat the dividend as "mineral income." The bill also provides that a taxpayer may treat the portion of his distributable share of income of a partnership as mineral income to the extent it is derived from foreign mineral activities of the partnership.

Once the income of a taxpayer is divided into the mineral and non-mineral categories, your committee's bill results in a disallowance of foreign taxes as a credit against U.S. tax to the extent the excess of foreign tax over U.S. tax on the mineral portion of the taxpayer's income is attributable to the allowance of percentage, rather than cost, depletion for U.S. income tax purposes. Under this rule, foreign and U.S. taxes may be compared on the foreign mineral income of the taxpayer as a whole under the overall limitation, or they may be compared on a per country basis. However, if a foreign tax is disallowed under this provision in the year paid or accrued, it is not permitted to be treated as a carry back or a carry forward to another taxable year.

This provision does not affect taxpayers who do not claim percentage depletion on income from extraction of foreign minerals. Moreover, it does not affect taxpayers who claim percentage depletion on such income for Federal income tax purposes if the foreign tax allocable to their foreign mineral income is equal to or less than the U.S. tax applicable to the same income assuming the taxpayer used cost, rather than percentage, depletion for U.S. tax purposes.

(*c*)(*i*) *Effective date.*—This provision applies with respect to the computation of foreign tax credits for taxable years beginning after December 31, 1963.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible increase in revenues.

39. Sale of residence by employee (sec. 232 of the bill and sec. 1003 of the code)

(*a*) *Present law.*—Under present law, amounts received by transferred employees from their employers in reimbursement of "losses," selling commissions, and legal fees incident to the sale of a principal residence have been held to be as ordinary income. *Harris W. Bradley*, 39 T.C. 652 aff'd 324 F. 2d 610 (4th Cir. 1963).

Prior to the *Bradley* opinion the treatment of these reimbursements was governed by a 1947 opinion of the Tax Court which treated the reimbursed amount as part of the selling price of the old residence (*Schairer*, 9 T.C. 549). This had the effect of providing capital gains treatment on the reimbursed amount if there was an overall gain on the sale and if the proceeds were not reinvested in a new residence. If, on the other hand, there was a loss on the sale of the old residence, the reimbursement received from the employer was not taxed.

(*b*) *General reasons for provisions.*—Your committee believes that treating reimbursements for selling expenses and "market value losses" as part of the proceeds from the sale of the old residence if the sale occurs because of an employee's transfer to a new place of work recognizes the practical effects of the transaction and treats the employee much as if he had not been required to sell his home under forced circumstances.

These transfers may be for the convenience of the employer, not the

employee, and they often occur unexpectedly. In these cases the employee may be unable to sell his residence on a normal market but must dispose of it promptly, often when market conditions are most unfavorable. In many cases an employer may transfer a great many of his employees at one time. This may have a depressing effect on the home market for which the employer is largely responsible, and his reimbursements of his employees' selling expenses is only equitable.

Your committee believes that in a case of this type the employees are likely to derive no economic advantage from the reimbursements from their employers and that as a result it is unfortunate to treat these reimbursements as compensation.

(c) *General explanation of provisions.*—For these reasons, your committee's bill treats reimbursements received by employees from their employers for selling expenses and market value losses arising from the "forced" sale of their residence (within a limited period from the employee's transfer to a new place of work) as an additional amount realized on the sale of the old residence. The provision limits the amount of reimbursement which may receive this treatment to the lesser of (A) the sales differential, or (B) 15 percent of the gross sales price of the old residence. "Sales differential" for this purpose means the amount by which (A) the appraised value of the old residence exceeds (B) the gross sales price of the old residence, reduced by the selling commissions, legal fees, and other expenses incident to the transfer of ownership of the old residence. In no event, however, is the appraised value, for purposes of (1) above, to exceed the fair market value of the old residence.

The bill further provides that this treatment is to apply only where the employee sells his house during the "forced sale" period; that is, the period beginning 90 days before and ending 180 days after the date on which he commences work as an employee at his new principal place of work. In addition, for the new rule to apply, the employee's commuting distance must, as in the case of the deduction for moving expenses under section 213 of the bill, be increased by at least 20 miles. This prevents the provision from applying to purely local moves. Finally, the individual receiving the reimbursement must have been an employee of the reimbursing employer for at least 6 months prior to the transfer.

(c)(i) *Illustrations.*—The following illustrations indicate the operation of this new provision in cases where the proceeds from the sale are not reinvested in a new residence and compares the result under the new provisions with the tax consequences under the Bradley decision.

Illustrations of provision

	Case A	Case B	Case C
Gross sales price of old residence	$30,000	$30,000	$30,000
Real estate commission	1,800	1,800	1,800
Legal fees incident to closing	200	200	200
Amount of reimbursement by employer	2,000	5,000	3,000
Average of appraisals of old residence	30,000	33,000	31,000
Fair market value of old residence	30,000	33,000	30,000
Cost of old residence	20,000	33,000	30,000
Tax consequences:			
1. Sec. 232:			
(a) Ordinary income	0	500	1,000
(b) Capital gain	10,000	0	0
2. Existing law, *Bradley* decision:			
(a) Ordinary income	2,000	5,000	3,000
(b) Capital gain	8,000	0	0

Case A indicates that where a residence is sold for its full value (which exceeds its cost), reimbursements received by the transferred employee for selling commissions and closing costs serve to increase the amount of capital gain otherwise realized on the sale.

Case B shows the application of the 15-percent limitation in a situation involving a loss based upon both fair market value and the employee's cost. In this case $500 of the reimbursed amount (the portion of the $5,000 reimbursement in excess of 15 percent of gross selling price) is not considered part of the amount realized on the sale.

Case C shows the fair market value limitation. Here, the old residence was sold for its value (which equaled its cost), but the employee was reimbursed $1,000 for a "loss" he did not incur. Under the provision, this $1,000 is not considered part of the amount realized on the sale.

(*c*)(*ii*) *Effective date.*—The amendment made by this provision shall apply to reimbursements received with respect to sales contracts entered into after December 31, 1960, in taxable years ending after such date.

(*d*) *Revenue effect.*—This amendment is expected to result in a revenue loss of $45 million in a full year of operation.

40. Dispositions of depreciable real estate (sec. 233 of the bill and sec. 1250 of the code)

(*a*) *Present law.*—Under present law, taxpayers may take depreciation on real property (other than land) used in a trade or business or held for the production of income. The depreciation methods available are the same as those applying to tangible personal property. They include (1) straight-line depreciation; (2) 150 percent declining balance depreciation; (3) double-declining balance depreciation; (4) sum-of-the-years-digits depreciation; and (5) any other consistent method of depreciation which does not during the first two-thirds of the useful life of the property result in greater depreciation than under the double-declining balance method. The 150-percent declining balance method is available with respect to used real property only under certain circumstances. The last three methods of depreciation referred to are available only for property with a useful life of 3 years or more and only if the property was new property in the hands of the taxpayer.

The depreciation is allowed as a deduction against ordinary income. As the depreciation deduction is taken the cost or other basis of the real property is reduced by a like amount. If the property subsequently is sold, any gain realized on the difference between the sales price (adjusted downward for selling expenses) and the adjusted basis of the property is taxed as a capital gain if the total transactions in depreciable property and certain other property (referred to in sec. 1231) result in a gain for the year involved. On the other hand, where the aggregate of these transactions results in a loss, the net loss is an ordinary loss.

(*b*) *General reasons for provisions.*—Since the depreciation deductions are taken against ordinary income while any gain on the sale of the property is treated as a capital gain, there is an opportunity under present law in effect to convert ordinary income into capital gain. This occurs whenever the depreciation deductions allowed reduce the basis of the property faster than the actual decline in its value.

Congress in the Revenue Act of 1962 recognized the existence of this same problem in the case of gains from the disposition of depreciable machinery and other personal property. In that act, the Congress provided that any gain realized on the sale of these assets in the future would be ordinary income to the extent of any depreciation deductions taken in 1962 and subsequent years with respect to the property.

In the case of real estate, this problem is magnified by the fact that real estate is usually acquired through debt financing and the depreciation deductions allowed relate not only to the taxpayer's equity investment but to the indebtedness as well. Since the depreciation deductions relate to the indebtedness as well as the equity in the property, this may permit the tax-free amortization of any mortgage on the property. As a result in such cases there is a tax-free cash return of a part of the investment which may in fact enable the taxpayer to show a loss for several years which he may offset against income for tax purposes.

In 1962, Congress did not include real property in the recapture provision applicable to depreciable personal property because it recognized the problem in doing so where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period of time. The bill this year takes this factor into account. It makes sure that the ordinary income treatment is applied upon the sale of the asset only to what may truly be called excess depreciation deductions. It does this first by providing that in no event is there to be a recapture of depreciation as ordinary income where the property is sold at a gain except to the extent the depreciation deductions taken exceed the deduction which would have been allowable had the taxpayer limited his deductions to those available under the straight-line method of depreciation. Secondly, a provision has been added which in any event tapers off the proportion of any gain which will be treated as ordinary income so that it disappears gradually over a 10-year holding period for the real estate. As a result, under the bill, no ordinary income will be realized on the sale of real estate held for more than 10 years.

(*c*) *General explanation of provisions.*—In view of the considerations set forth above, the House and your committee have amended present law to provide that when depreciable real estate is sold after December 31, 1963, in certain cases a proportion of any gain realized upon the sale of the property is to be treated as ordinary income; that is, previous depreciation deductions against ordinary income are to be "recaptured" from the capital gains category.

The bill accomplishes this result by treating as ordinary income a certain percentage of what is called "additional" depreciation or the amount of gain realized on the sale of the property, whichever is smaller.[1] Generally, the "additional" depreciation referred to here is that part of the depreciation deductions which exceeds the depreciation deductions allowable under the straight-line method. The depreciation deductions taken into account, however, are only those taken after December 31, 1963. Thus, they are the excess of any depreciation deductions taken under the double-declining balance method,

[1] This provision also applies to certain dispositions where there is not a sale or exchange. Therefore, the bill refers not only to the excess of the amount realized over the adjusted basis of the property but also, so that the provision will apply to these dispositions which are not sales or exchanges, it refers to the excess of the fair market value of the property over its adjusted basis.

sum-of-the-years-digits method, or other method of rapid depreciation, over the depreciation which would have been taken under the straight-line method. In the case of property held for 1 year or less, however, the deductions recaptured are to include not only the excess over straight-line depreciation, but rather the entire depreciation deductions taken.

The bill limits the depreciation recapture to the excess over straight line depreciation because it is believes that only to this extent could the depreciation taken appropriately be considered in excess of the decline in the value of the property which occurs over time. If a gain still occurs, it is believed that this is attributable to a rise in price levels generally rather than to an absence of a decline in the value of the property. The portion representing the rise in value is comparable to other forms of gains which quite generally are treated as capital gains. Moreover, it is believed that when the property is held for an extended period of time, gains realized on the sale or other disposition of the property are more likely to be attributable to price rises generally than to an excess of depreciation deductions. For that reason, the bill also tapers off over a 10-year period the proportion of the additional depreciation (or gain where smaller) which is to be treated as ordinary income upon the sale of the property.

This is accomplished by providing that the additional depreciation (or gain if smaller) which otherwise would be treated as ordinary income is to be decreased by 1 percentage point for each full month the property is held in excess of 20 full months. Thus, the amount which will be treated as ordinary income in the case of property held for a full 21 months would be 99 percent (the applicable percentage) of the amount which otherwise would be so treated. This decreases 1 percent for each succeeding month the property is held until the applicable percentage decreases to zero for property held for 10 years or more.

The property which is to be given the type of treatment described above is depreciable real property other than real property which is eligible for the investment credit. Such property is already subject to the recapture rule provided by section 1245 which generally applies to tangible personal property. The types of real property, therefore, which are not subject to this provision are property other than buildings or structural components which are used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services or represent research or storage facilities used in connection with these activities. Examples of the types of real property which, therefore, are not included under this provision are railroad track and bridges and blast furnaces.

This provision applies only to the additional depreciation allowed or allowable. Consequently, the enactment of this provision is not intended to affect the question of whether all or any part of a claimed deduction for depreciation is in fact allowable. For example, since in the year real property is sold the actual value of the property is known, it has been held that depreciation deductions should not be allowed to the extent they reduce the adjusted basis of the property below the actual amount realized. This provision, in providing for ordinary income treatment for certain additional depreciation, is not intended to affect this holding.

(*c*)(*i*) *Substantial improvements.*—Because the percentage of additional depreciation (or gain, if smaller) decreases after the first 20

months by 1 percent a month, it is necessary to determine when property has been acquired. This presents a special problem where real estate already held is substantially improved. To consider the substantial improvement as being held for the same period as the original investment in the property would mean that where property has been held for 10 years or more there would be no ordinary income arising with respect to substantial improvements, even though these improvements might have been made within the last few years. To prevent avoidance of the ordinary income treatment provided by this provision, the bill defines a "separate improvement" which is treated as a separate element for purposes of determining the amount treated as ordinary income upon the sale or exchange of real property. Appreciation which may be treated as ordinary income is divided up among the separate elements in accordance with the additional depreciation deductions with respect to each element.[1]

A separate improvement is intended by the bill to be only an improvement which is of a substantial nature. Lesser improvements are treated as if they were a part of the original structure and do not take a new, or separate holding period for purposes of determining the proportion of the additional depreciation (or gain, if smaller) treated as ordinary income. As a result, separate improvements are defined under the bill as arising only where the cost of the improvements in question is greater than the largest of the following three amounts—

1. 25 percent of the adjusted basis of the property;
2. 10 percent of the original cost of the property plus the cost of any improvements made prior to those being considered here less the cost of retired components; or
3. $5,000.

These tests are applied over a 3-year period. Thus, if improvements made in any 3-year period increase the adjusted basis of the property before that period by 25 percent or more or exceed the amount specified under the other tests if larger, then this entire amount will be treated as a separate improvement. The 25-percent adjusted basis test in this case is expected to be the principal test applied; however, the 10-percent test will prevent a relatively moderate improvement in a fully, or almost fully, depreciated building from being classified as a substantial improvement. The $5,000 limitation is intended as a de minimis rule below which no aggregate amount in a 3-year period would be treated as a substantial improvement.

In applying the above test for determining whether an improvement is to be treated as substantial, improvements in any one of the 3 years are to be omitted entirely if they do not amount to at least $2,000, or 1 percent of the original cost of the property plus the cost of any improvements previously made (less the cost of retired components), whichever is the greater. As in the case of the $5,000 limitation, which applies over the 3-year period, these exceptions are designed as a de minimis rule to make it unnecessary to treat as separate improvements relatively minor improvements made in any one of the 3 years which may be involved in the computation in question.

In the future additional depreciation allowed over straight line depreciation is to be subject to recapture not only in the case of the

[1] In addition to the separate improvements, the bill also treats as separate elements units of real property which were placed in service at different times before initial completion of the building.

double-declining balance and other forms of rapid depreciation available only in the case of new property, but also the excess over straight line depreciation is to be recaptured in the case of depreciation, such as the 150-percent declining balance depreciation which presently is permitted with respect to used real property under certain circumstances.

(c)(ii) *Disposition where ordinary income is recognized.*—Ordinary income under the bill is recognized not only in the case of the sale or exchange of real property but also in the case of all other types of dispositions unless a specific exception is provided. Thus, as in the case of the provision enacted in 1962 in connection with tangible personal property, this provision may result in the recognition of ordinary income even though capital gain might not otherwise have been realized at the time of such a disposition. The bill provides seven general categories of exceptions, however, where dispositions are not to result in the recognition of any ordinary income.

The first exception is for gifts. Thus, the making of a gift for this purpose will not be a taxable event. However, the depreciation deductions of the donor in such a case are carried over to the donee. As a result, if the donee subsequently sells the real property, there may be ordinary income recognized by him as a result of depreciation deductions taken by the donor. The donee in such a case, however, will receive the benefit of the holding period of the donor. The effect, therefore, of this is to treat the donor and donee for purposes of this provision as if they were one person, with the result that upon the subsequent sale by the donee of the property, the same amount (if any) will be treated as ordinary income as if the donor held the property throughout the entire period. Similarly, in determining the percentage decrease in total gain to be taken into account as ordinary income, the holding period of both the donor and the donee is taken into account. This, of course, means that a smaller proportion of the gain will be treated as ordinary income than would be true if only the donee's holding period were used for this purpose.

In the case of real property which is given to a charitable organization, although no income is realized by the donor at the time of the gift, the bill provides that the amount of the charitable contribution deduction he may receive is reduced by the amount which would have been treated as ordinary income had the real property been sold at its fair market value (amendment to sec. 170(e)). This conforms with the treatment provided in 1962 by Congress with respect to tangible personal property contributed to a charity.

A second exception to the recognition of ordinary income upon the disposition of real property is provided in the case of transfers at death (except where the sale has occurred before death, in which case the amount is treated as income with respect to a decedent under sec. 691). In this case, however, there is no carryover of the income potential of the depreciation deductions to the decedent's devisee or heir.

A third category of exceptions to the recognition of ordinary income is provided in the case of a series of transactions which generally are tax free and in which the basis of the real property is carried over from the former to the new owner. However, in these transactions where there is any gain recognized because the exchange is accompanied by "boot" (i.e., money or its equivalent) then to the extent of

this gain, ordinary income may be recognized or to the extent of the applicable percentage of the additional depreciation deductions if smaller. The tax free transactions referred to relate to those occurring upon the complete liquidation of a subsidiary (sec. 332); in the case of a transfer for stock or securities to a corporation controlled by the transferor (sec. 351); in the case of a transfer of property by a corporation which is a party to a reorganization in pursuance of a plan of reorganization solely for stock or securities in another corporation also a party to the reorganization (sec. 361); and in the case of reorganizations in certain receivership and bankruptcy proceedings (secs. 371(a) and 374). Also included in the same category are contributions of real property to a partnership in exchange for an interest in the partnership, and distributions by a partnership of real property in partial or complete liquidation of an interest in the partnership (but in this respect, see the special partnership treatment described below). Under the bill, however, there will be a recognition of ordinary income where there is a contribution of depreciable property to a tax exempt organization (other than an exempt farm cooperative) in exchange for stocks or securities in the exempt organization. Recognition of gain in this case, as in the case of tangible personal property in the provision added last year, is provided because a disposition of the property by the exempt organization ordinarily would escape the realization of the ordinary income with respect to these deductions.

A fourth category of exceptions is provided in the case of so-called like-kind exchanges of real property used for production or investment and for involuntary conversions. In exchanges of these types, the ordinary income recognized is in general limited to any appreciation in value attributable to depreciable real property which is not reinvested, after the exchange or involuntary conversion into other depreciable real property. Thus, ordinary income will be recognized to the extent of the additional depreciation, decreased according to the holding period involved, or by the following amount of appreciation, whichever is the smaller. First, to the extent that the exchange or conversion results in actual gain being recognized, this will be treated as ordinary income under the general rule. Second, this gain will be increased by stock purchased in a corporation even though under the involuntary conversion provision this generally would not result in the recognition of gain. This amount is treated as potential ordinary income since any subsequent sale of the stock does not represent the sale of a depreciable asset and, therefore, it would not be possible in this event to recapture the depreciation. Third, to the extent of any remaining appreciation represented by real property, ordinary income is recognized to the extent this unrealized appreciation cannot be included in the basis of the newly acquired real property. Under this provision, the newly acquired real property will, upon its sale or other disposition, give rise to the same ordinary income, decreased according to the holding period for the newly acquired property, as would the previously held real property (except to the extent that ordinary income was recognized at the time of the conversion). The holding period for purposes of determining the percentage of the additional depreciation which is to be treated as ordinary income is begun anew with respect to the exchange or converted property, but the new holding period applies only to the percentage of the gain which would have been taken into account had the property held been sold at the time of the exchange or conversion.

A fifth exception is provided in the case of the exchange or sale of property in obedience to Federal Communications Commission orders or orders of the Securities and Exchange Commission (secs. 1071 and 1081). In these cases, also, the ordinary income includes not only the actual gain recognized but also the appropriate percentage of any depreciation charges unrecovered at the time of the sale or exchange which are not reinvested in other depreciable real property.

A sixth exception is provided in the case of distributions of real property by a partnership to a partner. A distribution of real property by a partnership to a partner, to the extent that the distribution represents the partner's share of unrealized appreciation attributable to this property, is not to result in ordinary income to the distributee partner at the time of the distribution. However, the unrealized appreciation representing additional depreciation taken by the partnership will be carried over to the distributee partner. When he disposes of this real property, the unrealized appreciation represented by these partnerships (or by an earlier transferee where the partnership acquired the property without recognizing gain), additional depreciation deductions will be taken into account in a manner substantially the same as that applying where the taxpayer himself took the depreciation deductions. This rule applies only to the extent a partner is considered as receiving his share of the real property to which is attributable potential ordinary income. An amendment made elsewhere to the code (sec. 751(c)) provides that in other cases the ordinary income element in real property is to be considered as "unrealized receivable." Thus, to the extent of applicable percentage of the additional depreciation deductions taken (or potential gain, if smaller) ordinary income will be recognized in the case of the sale of a partnership interest, in the case of a distribution to a retiring or deceased partner, and in the case of distributions to a partner where he receives either more or less than his proportionate share of real property reflecting this ordinary income.

A seventh exception deals with the case where the property being disposed of by the taxpayer is his principal residence. Under present law (sec. 1034) where the taxpayer sells his principal residence and within a year before or after this sale (18 months after in the case of the construction of a new home) purchases or builds another, then any gain realized on the sale of the first residence is not recognized for tax purposes to the extent the total proceeds from the sale of the first residence are invested in the second. The bill provides that in cases of this type, to the extent the full proceeds from the sale of the first residence are reinvested into a second, no ordinary income is to be recognized at that time.

Similarly, the bill provides no recognition of ordinary income potential with respect to the provision incorporated elsewhere in this bill (sec. 206 of the bill) which provides that no gain is recognized by a taxpayer age 65 or over who sells a home which he has used as a personal residence and owned for 5 out of the last 8 years.

As in the case of the provision enacted in 1962 relating to tangible personal property, the House and your committee in this provision found it necessary to recognize ordinary income in cases where capital gain is not recognized under existing law. This was done primarily in those cases where the transferee receives another basis for the property than that of the transferor. This treatment is provided in three types of cases where a distribution is made by a corporation without

the payment of a tax at the corporate level on unrealized appreciation in value; namely, where the real property is distributed as a dividend (sec. 311), where the real property is distributed as part of a partial or complete liquidation by a corporation (sec. 336), and where in a plan of complete liquidation a corporation sells the real property (and perhaps other assets) and within a 12-month period completes the liquidation of the corporation (sec. 337). Similarly, if the real property is first sold by a corporation for installment notes and the gain which would be realized on such sale is delayed because of the installment method of reporting, a distribution of these notes to the shareholder in a liquidation under section 337 (12-month liquidation) results under this bill in the recognition of the same amount of ordinary income of the corporation as would have been realized on a cash sale of these notes. The same rule is applied whenever similar installment notes are distributed by a corporation in a liquidation in which the basis of the real property to the receiving shareholder is determined under section 334(b)(2) (purchase of 80 percent of the stock of one corporation by another corporation followed by immediate liquidation of the corporation acquiring). The other situations where ordinary income may be realized under this provision although capital gain would not otherwise occur, include the case where distribution is made by a partnership and the partner gives up, or acquires, more than his proportionate share of this real property. Other cases include the provision relating to the exchange of like-kind property, involuntary conversions, sales or exchanges to effectuate FCC policy, and exchanges in obedience to orders of the SEC. In all of these cases where the property received in exchange for depreciable real property is not itself depreciable real property, then ordinary income is recognized.

(c)(iii) *Leasehold improvements.*—Improvements made to property held under a lease by a lessee present a special problem in determining what is the amortization period equivalent to the straight-line depreciation method selected as the norm in the usual case. Present law (sec. 178) in general provides that leasehold renewal periods are to be taken into account in determining amortization or depreciation with respect to any year if the initial lease period remaining is less than 60 percent of the useful life of the building or other improvement, or if less than 75 percent of the cost of the lease is attributable to the remaining portion of the initial lease period, and if it is more probable that the lease will be renewed, extended, or continued than that it will not. Such a test is appropriate when looking forward to amortization deductions in future years. However, it does not represent an adequate norm for the measurement of excess or additional depreciation after the deduction has been taken and the lease is being sold.

As a result, the bill provides that in determining the norm for purposes of specifying additional depreciation which may be treated as ordinary income, periods for which a lease may be renewed, extended, or continued under an option exercisable by the lessee are generally to be taken into account. However, the renewal periods so taken into account are not to extend the amortization period by more than two-thirds of the initial lease period remaining after the improvement was made. Thus, in the case of a 6-year lease with a 6-year renewal period, only 4 additional years are to be taken into account in determining the amortization period of an improvement made at the beginning of the initial lease. Thus, in this case, the amortization

payments with respect to the lease would be spread over a 10-year period and payments in excess of such a spreading would be considered additional depreciation adjustments. However, if the useful life of the asset itself in such a case were less than 10 years, then the depreciation deductions would be spread for this purpose in a straight-line method over the useful life of the asset, and this would be used as the measure in determining additional or excess depreciation adjustments.

(c)(iv) *Effective date.*—This provision is to apply with respect to depreciation attributable to periods after December 31, 1963, and to dispositions of property after that date.

(d) *Revenue effect.*—Since this provision relates only to depreciation deductions in 1964 and subsequent years, the initial revenue impact of this bill is expected to be small. In fiscal year 1965, it is expected that this provision will result in a revenue gain of about $5 million. In subsequent years, however, when the provision becomes fully effective, it is anticipated that it will result in a revenue gain of approximately $15 million a year.

41. Income averaging (sec. 234 of the bill and secs. 1301–1305 of the code)

(a) *Present law.*—Present law does not provide any generally available income averaging provision for the persons whose income fluctuates widely from year to year. Instead, present law contains six specific averaging provisions dealing with special types of situations: Certain compensation for personal services, income from inventions or artistic work, certain income from backpay, compensation for damages for patent infringements, breach of contract damages, and damages for injuries under the antitrust laws.

In the case of the provision relating to compensation for personal services and that relating to inventions and artistic works, in order to be eligible for this treatment, the employment involved must have covered 36 months or more in the case of the compensation for personal services, and in the case of the work on the inventions or the artistic works must have covered a period of 24 months or more. In addition, eligibility under these same two provisions required that the receipts of the payments involved with respect to the work be heavily concentrated in 1 year. In the case of compensation for personal services, 80 percent or more of the total compensation for the employment must have been received in the taxable year in question. In the case of the invention or artistic work, the amount received in the year in question must not be less than 80 percent of the gross amount received with respect to the invention or artistic work in the taxable year, all prior years, and the succeeding 12 months. The backpay provision also has a somewhat similar provision. To be eligible for averaging in the case of backpay, the amount of backpay received in the taxable year must exceed 15 percent of the gross income for that year.

In the case of all of the present averaging devices, the averaging is achieved by providing that the tax involved is not to be greater than if this income were spread back, either ratably over the period to which the income relates, or to the specific years to which the income relates. However, in the case of income from inventions, the spread back for this purpose may not exceed 60 months, and in the case of artistic work it may not exceed 36 months. The other averaging

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provisions are not limited in this respect. The tax in each case, although imposed as of the current year, is determined by making a recomputation with respect to one or more back years.

(*b*) *General reasons for provisions.*—A general averaging provision is needed to accord those whose incomes fluctuate widely from year to year the same treatment accorded those with relatively stable incomes. Because the individual income tax rates are progressive, over a period of years those whose incomes vary widely from year to year pay substantially more in income taxes than others with a comparable amount of total income but spread evenly over the years involved. This occurs because the progressive rates take a much larger proportion of the income in taxes from those whose incomes in some years are relatively high. The absence of any general averaging device has worked particular hardships on professions or types of work where incomes tend to fluctuate. This is true, for example, in the case of authors, professional artists, actors, and athletes as well as farmers, fishermen, attorneys, architects, and others.

The present averaging provisions have proved unsatisfactory, first because they are limited to a relatively small proportion of the situations where averaging is needed. Thus, while they presumably cover inventors and writers, they do not provide for actors, athletes, and in most cases do not provide for attorneys, architects, and others. Even in the case of inventors and authors, the present provision is inadequate because of the requirement that the income arise over at least a 24-month period and 80 percent or more of the income from the invention or work be concentrated in the current year in question. In practice, many cases involving authors and inventors where averaging is needed do not meet these specific requirements. This was made clear in testimony from authors and others.

The present averaging provisions also have proved unduly complicated in practice because of the requirement that the prior years' incomes and taxes must be recomputed as if the income had actually been received in those prior years.

Your committee agrees with the House that income averaging should be designed to treat everyone as nearly equally for tax purposes as possible, without regard to how their income is spread over a period of years and without regard to the type of income involved. At the same time, it is necessary to have any income averaging device in a form which is workable, both from the standpoint of the taxpayer and the Internal Revenue Service.

Although the bill generally repeals the averaging devices in present law (secs. 1301–1307), it is recognized that cases may arise where a person has entered into long-term contingent employments upon the assumption that the averaging device in present law applicable to compensation from an employment would be available. Since employments in some cases may last for extended periods of time, such as 20 years, the general 5-year averaging device might produce less favorable treatment than the present provision. As a result, the bill provides, in the case of these long-term employments which were already in being before 1963, for the taxpayers involved to continue the form of averaging available under present law if they elect to forgo the general 5-year averaging provided in this bill.

(*c*) *General explanation of provisions.*—In view of the considerations set forth above, the bill deletes all of the averaging provisions in

present law referred to previously and substitutes instead an income averaging device available to individual taxpayers generally, substantially without regard to the source of the income. As indicated subsequently, however, in the case of the averaging device for compensation from an employment, the bill in certain cases permits the continuance of the application of this provision.

Under the averaging rule provided by the bill, once the amount of income to be averaged is determined—called averageable income in the bill—and assuming this amount is more than $3,000, the taxpayer is to compute a tentative tax on one-fifth of this amount. The tax on this one-fifth is determined by adding this one-fifth to 1⅓ times the average income received in the prior 4 years, plus the average capital gains income in this same 4-year period. The tax attributable to this one-fifth is then multiplied by 5 to determine the final tax on this income.

Averaging is available only where the "averageable income" exceeds $3,000 because, with the present progressive rate structure with tax brackets usually of $2,000 to $4,000, smaller amounts achieve little if any benefit from averaging. The device of including one-fifth of the averageable income in the tentative tax base, computing the tax attributable to this amount, and then multiplying this result by 5, achieves a result which is substantially similar (except when there are rate changes during the 5 years) to including one-fifth of the income eligible for averaging in the taxable income base of each of the prior 4 years and of the current year. The advantage of making the computation in this manner is that it is not necessary to recompute the tax for each of the 4 prior years in order to obtain this result.

The "averageable income" referred to here is the excess of the taxable income in the current or computation year—with certain adjustments—over 1⅓ times the average base period income. The average base period income is the average of the taxable income in the 4 prior years with certain adjustments specified below.

Averageable income is limited to that which is in excess of 1⅓ times average income in the base period for two basic reasons. First, in any new provision of this type, it is necessary to limit the number of cases to which the new provision will apply to a manageable level from the administrative standpoint. In other words, it was necessary initially, at least, to limit the volume of cases where averaging will be applied. Moreover, it is clear that the greatest need for averaging occurs where the fluctuation in income levels varies widely. An increase of more than one-third from the prior average income was selected to make the new averaging rule available in those cases where it is needed the most.

As indicated above, in computing the income subject to averaging, it is necessary to make some adjustments in both the income of the current, or computation year, and also in the income of the 4 base period years with which the current year's income is compared. The income of the computation year, referred to in the bill as the "adjusted taxable income" is the taxable income for that year decreased by: (1) Any capital gain net income for that year; (2) any income for that year attributable to gifts, bequests, devises, or inheritances received during that year or any of the four prior base period years;[1]

[1] Income attributable to gifts, bequests, devises, or inheritances between a husband and wife are not taken out of the income for the computation year if they file a joint return for the computation year or one of them makes a return in that year as a surviving spouse. Also not taken into account are amounts of less than $3,000 in computation year.

(3) any excess of wagering gains in the year over wagering losses; and (4) certain amounts of income to which penalties apply with respect to owner-employees who are self-insured for pension plan purposes (sec. 72(m)(5)).

Long-term capital gains are excluded from the income subject to averaging in the computation year on the grounds that such income does not require averaging because of the fact that only 50 percent of the capital gain income is included in the tax base in any event. Moreover, without regard to the averaging provision, such income is subject to a maximum rate of 25 percent.

Averageable income also excludes income from gifts, devises, or inheritances where the gifts, etc., have been received either in the computation year or in any of the four prior base period years, because such income does not arise from any additional efforts on the part of the taxpayer but merely represents a transfer to the taxpayer of income previously received by someone else. In addition, in the case of the transfer by gift of income producing properties between related parties, there would be some opportunity for manipulation if such income were not excluded from that which can be averaged. Income attributable to such property is excluded under the bill only where it is in excess of $3,000 in the computation year. Also, because it may be difficult to trace specific income to specific gifts, bequests, devises, or inheritances, the bill presumes that such property earns a 6-percent rate of return unless the taxpayer establishes to the satisfaction of the Treasury that some other amount of income is earned with respect to the property.

Net wagering gains are excluded from averageable income to prevent such income from receiving a preferred status. For similar reasons, penalty income of owner-employees in the case of self-insured pension plans is excluded.

It is also necessary to make some adjustments in the base period income with which the adjusted taxable income for the computation year is compared. Two of these adjustments are the same as those made in the computation year. Thus, capital gain net income for the base period year is excluded as is any income from gifts, bequests, devises, or inheritances where such property was initially received by the taxpayer in 1 of the 4 base period years.

A third adjustment made to the average base period income is to add back to such income any income excluded from the taxpayer's base in such year on the grounds that it was earned in a foreign country (the exclusion under sec. 911 of present law) or on the grounds that it was income from sources within a possession of the United States (sec. 931 of present law). The inclusion of such amounts in the base period is necessary so that the taxpayer will not become eligible for averaging merely on the grounds that during the 4-year base period, or a part of this period, he was in a foreign country and not subject to U.S. tax on his earned income. If such amounts are not included in the base period income comparable amounts earned in the United States in the computation year would be eligible for averaging.

(c)(i) *Example.*—For most taxpayers with little or none of the income which gives rise to the special exceptions described above the application of this averaging provision is relatively simple. This can be illustrated by an example of an unmarried taxpayer having an average base period income of $3,000 in the years 1961–64 and an adjusted taxable income of $44,000 in 1965. The taxpayer in this

case is eligible for averaging since his "averageable income" exceeds $3,000. His averageable income in this case can be computed as follows:

1. Adjusted taxable income in computation year	$44, 000
2. 133⅓ percent of average base period income ($3,000× 133⅓ percent)	4, 000
3. Averageable income	40, 000

Since the averageable income is in excess of $3,000, the entire amount is subject to averaging.

Computation of tax:

(a) 133⅓ percent of average base income ($3,000× 133⅓ percent)	4, 000
(b) Averageable income included in tentative tax base (⅕ of $40,000)	8, 000
(c) Tentative taxable income	12, 000
(d) Total tentative tax liability (1965 rates under bill)	2, 830
(e) Tax on $4,000 not subject to averaging	690
(f) Tax liability on ⅕ of averageable income	2, 140
(g) Tax on total averageable income ($2,140× 5)	10, 700
(h) Total final tax liability (tax on $4,000 not subject to averaging and $40,000 subject to averaging)	11, 390
(i) Tax on $44,000 under 1965 rates without averaging	18, 990

(c)(ii) *Treatment of capital gains and priority of taxing different types of income.*—As previously indicated, net capital gains—any excess of net long-term gains over capital losses—are excluded from the adjusted taxable income for the computation year in determining how much of this income is to be eligible for averaging and also from the average base period income. Thus, generally, capital gains (other than short-term capital gains) have no effect in determining the income subject to averaging. There is one exception to this general rule, however. If the average capital gain net income in the base period exceeds the capital gain net income in the computation year, then to the extent of this excess the income subject to averaging is reduced. Generally, it was thought that capital gains should be set apart and not taken into account in averaging since they, in effect, have their own specialized form of averaging. However, in those cases where the average capital gains in the base period exceed the capital gains in the computation year, it is believed that averaging should be permitted only when total taxable income of the current year is substantially greater than the average of the base period.

The bill provides that in determining the tax which is attributable to the income subject to averaging, the first income subject to tax is to be the ordinary income not eligible for averaging. In the example previously presented, this meant that the $4,000 of income not subject to averaging was considered to be the income subject to the first income brackets. The income subject to the next higher income rates is the capital gain net income of the computation year but only to the extent [1] this does not exceed the average base period capital gain net income. Following this is the income subject to averaging, with respect to which one-fifth is included, the tax then computed, and the result multiplied by 5. Any remaining capital gains income in the computation year, in excess of average base period capital gain net income, is treated as coming on top of this income subject to averaging along with income from wagering or gifts, bequests, devises, or inheritances, which is not eligible for the averaging treatment.[2]

[1] Actually this amount is preceded by an amount equal to any excess of average base period capital gain over capital gains of the computation year in those infrequent cases where such income exists.

[2] The penalty income with respect to owner-managers in connection with receipt of pension-type income is treated as if the averaging provision did not apply.

The alternative capital gains tax in such a case is determined by applying 25 percent to the long-term capital gains. This tax then is compared with the tax attributable to the capital gains in the computation explained above. The reason for structuring the tax base in the manner indicated is to give assurance that the income subject to averaging is taxed, as nearly as possible, at the same income level as would be the case had such income been earned ratably over the current year and 4 prior years.

(c)(iii) *Eligible individuals.*—To be eligible for averaging, one of the principal concerns is that the individual's income must have been subject to tax by the United States throughout the entire base period as well as the computation year. No one is eligible for averaging who was a nonresident alien in any of the 4 base period years or in the computation year. To be eligible for averaging, the individual must be a citizen or resident in the computation year. In addition, even though a citizen in the computation year, the individual must be claiming no exclusion in that year for income earned abroad. He may have claimed such an exclusion with respect to a base period year, but, for purposes of determining his income in the computation year subject to averaging, this income is added back to his base period income.

A second concern of this provision is that the individual be a member of the labor force in both the computation year and in the 4 base period years. It has been necessary, however, to approximate this result in some cases. The general rule provides that the individual and his spouse must have furnished one-half or more of his own support in each of the base period years. However, it was not intended to exclude from the benefits of the averaging provision an individual who, although in the labor force, was unemployed in part or all of the base period years. For that reason, individuals generally are eligible for averaging if they are 25 years old and there have been at least 4 years since the individual attained age 21 when he was not a full-time student. Thus, generally, individuals age 25 or over will be eligible for averaging so long as they have been out of school for at least 4 years since age 21. A second exception is provided for the individual who, although not self-supporting in the 4-year base period, nevertheless, has income in the current year more than half of which is attributable in substantial part to work he has done in two or more of the base period years. This is designed to make sure that those who have performed some work of a substantial nature which occurred over a period of years will be eligible for averaging even though below the 25-year age limit. A third exception is provided for an individual who was not self-supporting in the base period and who makes a joint return with someone else if not more than 25 percent of the total adjusted gross income of the couple in the computation year is attributable to the individual in question. This means that an individual who has been in the labor force and who marries someone who was a dependent of another will not be deprived of averaging, assuming three-quarters or more of the income in the computation year is attributable to the individual who was in the labor force in the base period. This is designed to assure that a man who marries a woman who was a dependent of her father during part or all of the base period years is not deprived of income averaging as a result of this marriage.

(c)(iv) *Special rule with respect to marital status.*—No problems arise in applying the averaging provision where a husband and wife file a joint return in the computation year and also did so in each of the base period years. However, it is necessary to reconstruct their income where they either filed separately (or with other spouses) in the base period years or are filing separately in the computation year. For example, if a married couple files a joint return in the current year but filed separate returns for one or more base period years, their base period income for purposes of averaging in the current year will be their combined base period incomes for their base period years. In addition, the bill provides that an individual's base period income is to be either his actual base period income in each of the base period years or, if higher, 50 percent of the combined base period income of him and his spouse.[1] In determining actual income for purposes of this provision, community property laws are not to be taken into account with reference to income from personal services. Thus, the actual income attributed to an individual will be the income earned by him without regard to whose income it is considered to be under community property law.

(c)(v) *Continuance of present averaging device in certain cases.*—The bill provides that the averaging device in present law with respect to compensation from an employment is to continue to be available if the taxpayer so elects where he receives or accrues compensation from employment which began before February 6, 1963. If the taxpayer elects this treatment he must forgo for that year the generally available averaging device and the carryover of certain excess charitable contributions.

This provision, which on this elective basis is continued for compensation for the employment begun before the specified date, provides in general that the employment must cover a period of 36 months or more and that the gross compensation from the employment received by the individual (or partnership) in the year in question must not be less than 80 percent of the total compensation for such employment. Where these conditions are met, present law provides that the tax is not to be greater than if the compensation had been included in the gross income of the individual ratably over the period of the employment prior to the date of the receipt or accrual.

(c)(vi) *Effective date.*—The amendments made by this provision apply to taxable years beginning after December 31, 1963. This means that averaging will be available for the first time with respect to taxable years beginning in 1964. This will involve base period years as far back as 1960. However, as indicated previously, the averaging device in present law relating to compensation from employment where the employment began prior to February 6, 1963, may continue to be applicable for taxable years beginning after December 31, 1963, at the election of the taxpayer.

(d) *Revenue effect.*—This provision is expected to result in a reduction of $40 million of tax liabilities in the calendar year 1964 and subsequent years.

[1] If the individual involved was married to another person in one or more of the base period years, his base period income is to be not less than 50 percent of his income in that year combined with the income of whichever spouse had the higher income.

42. Small business corporations: Ownership of certain stock disregarded (sec. 235(a) of the bill and sec. 1371 of the code)

(*a*) *Present law.*—In 1958 Congress added to the Internal Revenue Code a new subchapter (sec. 1371 and following) which provides that the earnings of certain small business corporations may be taxed to the shareholders of the corporation (rather than taxing the corporate entity as such) in a manner somewhat similar to the way partnership earnings are taxed to the partners rather than to the partnership. Where the tax treatment provided by this subchapter is elected, the shareholders include in their own income for tax purposes the current taxable income of the corporation, both the dividends which have been distributed and the portion of the earnings which are still retained by the corporation. This treatment was provided in order to permit businesses to select the form of business organization desired without the necessity of taking into account major differences in tax consequences.

The right to elect the treatment provided under the new subchapter was limited to small business corporations in part because of the complexity involved in passing the earnings of a corporation through to its shareholders where the stock of the corporation is held by a widely diversified group of shareholders, and in part because it was thought that only the relatively small corporations were essentially comparable to the partnership or proprietorship where the earnings are taxed to the owners rather than to the business organization. As a result, Congress provided that corporations making this election must be domestic corporations which are not eligible to file a consolidated return with any other corporation. Also, they must have not more than 10 shareholders, their shareholders must all be individuals (or estates), no nonresident aliens may be shareholders, and the corporations may not have more than one class of stock.

(*b*) *General reasons for provision.*—Situations have been called to your committee's attention where corporations are denied the privilege of electing to have their income taxed to their shareholders (rather than to the corporation) merely on the grounds that the corporation owns the stock of completely inactive subsidiaries.

The establishment of inactive subsidiaries is a common business practice for corporations planning for future growth. Such corporations often desire to reserve their corporate name in States in which they are not yet doing business by establishing subsidiaries with the same or a similar name to that of the parent corporation. Your committee sees no reason to penalize the parent corporation by denying it the privilege of electing to pass the income through to its shareholders for tax purposes merely because, for business reasons, it has established these inactive subsidiaries which constitute an affiliated group which could file a consolidated return.

(*c*) *General explanation of provision.*—As a result of the considerations set forth above, this provision adds a new subsection to section 1371 of the code providing that a corporation will not be considered a member of an affiliated group for purposes of this election (and, therefore, not be denied the right to elect subch. S status) merely because it owns stock in another corporation which is inactive. An inactive corporation, in this case, is one that has not begun business after the date of its incorporation and before the end of the parent corporation's taxable year in question and that does not have taxable

income for this taxable year. If these conditions are met and the parent is not affiliated with any other corporation, an election may be filed under subchapter S by the parent corporation despite the rule that a subchapter S corporation may not be a member of an affiliated group. However, if the subsidiary corporation does not meet the conditions set forth above in a subsequent year, the parent corporation's subchapter S status would be terminated at that time.

(*c*)(*i*) *Effective date.*—This bill is effective for taxable years of corporations beginning after December 31, 1962.

(*d*) *Revenue effect.*—It is estimated that this provision will result in a negligible loss of revenue.

43. Small business corporations: Certain distributions of money after close of taxable year (sec. 235(b) of the bill and sec. 1375 of the code)

(*a*) *Present law.*—As indicated above, the earnings of small business corporations may be taxed to the shareholders of the corporation in a manner somewhat similar to the way partnership earnings are taxed to the partners rather than to the partnership. The shareholders are taxed each year on the dividend income received from the corporation plus any additional earnings of the corporation which are retained by it rather than distributed. If in a particular year such a corporation does not in fact distribute its earnings, any distributions in a later year are treated as dividend distributions to the extent of the earnings and profits of that later year. In addition, if in that later year the corporation has ceased being an "electing small business corporation" then all distributions are treated as being dividends to the full extent of both current and accumulated earnings and profits.

(*b*) *General reasons for provision.*—The rule stated above has created a problem where an electing small business corporation sells a capital (or depreciable) asset, adopts a resolution to distribute to its shareholders all or part of the proceeds of such sale, and then actually does distribute such proceeds in the year immediately following the year of sale. In such a case, even though the shareholders pay tax on the full capital gains in the year of the sale, the distribution to them in the later year will be treated as an ordinary dividend at least to the extent of the current earnings and profits of the later year. The result will be even harsher if in the later year the corporation has ceased being an electing small business corporation, because in this case the distribution will be a dividend to the extent of both the current and the accumulated earnings of the corporation.

(*c*) *General explanation of provision.*—To prevent the result described above, your committee's bill adds a provision to the effect that in the case of an electing small business corporation a distribution of money to the shareholders on or before the 15th day of the third month following the close of a taxable year, may, at the election of the corporation, be treated as a distribution of money made on the last day of the taxable year in question. This election is available whether or not the corporation involved is an electing small business corporation in the second year.

(*c*)(*i*) *Effective date.*—This amendment applies to taxable years beginning after December 31, 1957.

(*d*) *Revenue effect.*—It is anticipated that this provision will result in a negligible loss of revenue.

44. Repeal of additional 2-percent tax for corporations filing consolidated returns (sec. 236 of the bill and sec. 1503 of the code)

(*a*) *Present law.*—Under present law a consolidated income tax return may be filed by a group of parent and subsidiary corporations where there is 80 percent control of each level of the chain of corporations, and there is a common parent corporation; 80 percent control, in this case, means 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock. In the consolidated return, intercompany transactions are washed out, and it is possible to offset losses of one corporation against the gains of other members of the group. These intercompany transactions which are washed out also include intercompany dividends. As a result, dividends may be paid from one company in a consolidated group to another of the same group without the second member including in its income 15 percent of this dividend income.

Under present law, where the election to file a consolidated return is made, a special tax is levied equal to 2 percent of the consolidated taxable income of the group.

(*b*) *General reasons for provision.*—The bill removes the special 2-percent penalty tax on the privilege of filing a consolidated return, in part because the return of commonly controlled corporations as a single economic unit for tax purposes is in accord with the reality of the situation. Moreover, there appears to be no reason why, where a group of commonly controlled corporations are willing to have their operations consolidated for tax purposes, the mere presence of more than one corporate organization in the group should result in any penalty tax. No such penalty, for example, is exacted in the case of other corporate organizations operating through divisions rather than separate corporations.

In addition, the removal of this 2-percent penalty tax should encourage the filing of consolidated returns and serve as a brake on the expansion of the use of multiple surtax exemptions to gain tax advantages.

(*c*) *General explanation of provision.*—In view of the considerations set forth above, both the House and your committee's version of the bill repeals the special 2-percent tax on consolidated returns, effective with respect to taxable years beginning after December 31, 1963. This 2-percent tax presently applies to the consolidated taxable income of the affiliated group of includible corporations.

(*d*) *Revenue effect.*—The repeal of the 2-percent tax on consolidated corporate returns is expected to decrease revenues by $50 million a year.

45. Reduction of surtax exemption in case of certain controlled corporations (sec. 237 of the bill and secs. 1561–1563 of the code)

(*a*) *Present law.*—Under present law, corporations are taxed at a 30-percent rate on the first $25,000 of their taxable income and at a 52-percent rate on all income over that amount. This tax rate differential results from the fact that the first $25,000 of income of a corporation is subject to the 30-percent normal tax but is exempt from the 22-percent surtax, while income in excess of $25,000 is subject to both the 30-percent normal tax and the 22-percent surtax. This tax structure was intended to encourage small businesses which operate in corporate form. However, medium and large enterprises have in some cases taken advantage of the lower rates afforded small business by organizing their corporate structure in multiple corporate form.

As a result, the Internal Revenue Code contains several provisions designed to prevent taxpayers from using the multiple form of corporate organization, to avoid taxes. For example, present law provides (sec. 269) that where an individual or corporation acquires control of a corporation and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance, this deduction, credit, or allowance is not to be allowed. Also, elsewhere (sec. 1551) present law provides that if a corporation transfers part or all of its property (other than money) to another corporation created to acquire the property, or not actively engaged in business at the time of the transfer, and if there is common control of the two corporations, then the transferee corporation is not to be allowed the $25,000 surtax exemption or the $100,000 accumulated earnings credit unless it establishes by the clear preponderance of the evidence that the securing of the exemption or credit is not a major purpose of the transfer. In addition, present law (sec. 482) provides that where two or more corporations are owned or controlled directly or indirectly by the same interest, the Secretary of the Treasury or his delegate may allocate deductions, credits, or allowances between or among these corporations, if he determines that this is necessary to prevent evasion of taxes or clearly to reflect the income of the corporations.

(b) *General reasons for provision.*—This bill reduces the tax applicable to the first $25,000 of taxable income from 30 to 22 percent and decreases the tax applicable to income above $25,000 from 52 to 50 percent in 1964 and to 48 percent in subsequent years. One of the effects of this change is to increase the value of a surtax exemption from $5,500 (22 percent tax applicable only above $25,000, multiplied by the first $25,000 of income) per corporation under present law to $6,500 (26 percent tax applicable only above $25,000, multiplied by the first $25,000 of income) per corporation for 1965 and subsequent years.

While the importance to small business of reducing the tax on the first $25,000 of income from 30 to 22 percent is recognized, it is believed that this substantial tax reduction should not provide added inducement to existing medium and large corporations to split up into multiple corporations. Therefore, the bill limits the benefits of the tax reduction in cases where a parent corporation owns or controls one or more other corporations, or where a single individual, trust, or estate owns or controls two or more corporations.

By limiting the benefits of the tax rate reductions in the case of groups of multiple corporations, it is possible to grant a substantial tax reduction to small business in reducing the normal tax rate to 22 percent, as was recommended by the President, without granting the same benefits to medium and large enterprises which use, or might choose to use, the multiple corporate form of organization. The method of taxing controlled corporations contained in the bill will, in the opinion of the House and your committee, when coupled with repeal of the 2-percent additional tax on consolidated returns, encourage some controlled groups to file consolidated returns, while leaving groups which do not choose to file consolidated returns in approximately the same relative position they are in under present law.

While the House and your committee recognize the advantages of use of multiple corporations, it is believed, as it has been in the past,

that, where corporations owned and controlled by the same interests engage in different businesses in the same area or conduct the same type business in different geographical locales, there are legitimate business reasons for use of separate corporations and, therefore, the separate corporations should generally be recognized as separate taxpayers, retaining the benefit of use of multiple surtax exemptions. However, the House and your committee do not intend to encourage the formation of these multiple corporations and therefore propose to apply higher tax rates to corporations which are members of an affiliated group of corporations. Of course, nothing in this bill is intended as changing the application of sections 269, 1551, or 482 if the multiple corporation form of organization is adopted to avoid taxes.

(*c*) *General explanation of provision.*—If a controlled group exists, three basic alternatives are available to corporations which are members of the group:

(1) The corporations in the group may forego the use of multiple surtax exemptions, i.e., they each file separate income tax returns and allocate one $25,000 surtax exemption among the members of the group (and either elect or not elect the 100-percent dividends received deduction provided by sec. 215 of this bill).

(2) Corporations in the group may elect to pay a penalty tax and file a multiple surtax exemption return. Under this election each member of the group (subject to the tax avoidance provision) may claim a separate $25,000 surtax exemption, but each must also agree to pay an additional tax of 6 percent on the first $25,000 of its taxable income. With the generally applicable rates of 22 percent on the first $25,000 of taxable income and 50 percent or 48 percent on income over $25,000, this means a total tax for such companies of 28 percent on the first $25,000 of income and 50 percent in 1964 and 48 percent in 1965 and subsequent years on income over $25,000.

(3) A controlled group which also qualifies as an "affiliated group" of corporations may, as under present law, file a consolidated income tax return.

This third alternative is similar to the first alternative in that only one $25,000 surtax exemption is available to the corporations filing the consolidated return. However, there are additional benefits in filing a consolidated return arising from the ability to declare and receive dividends between members of the group without tax, and to offset losses of one company against another.

The bill does not attempt to achieve complete symmetry between the definition of a controlled group of corporations for purposes of foregoing multiple surtax exemptions and the definition of a group eligible to file a consolidated return. Several differences arise. However, many complicated problems are involved in equating the two, and many avoidance possibilities might be created if they were equated. Thus, for example, a foreign corporation doing business in the United States is included in the controlled group definition. However, if the foreign corporation is also doing business abroad and was permitted to join in a consolidated return, it could pass a dividend, out of its foreign earnings, tax free to the domestic parent, and thus escape all U.S. taxes. Moreover, neither the House nor your committee is aware of any situations in which the discrepancies in the two

definitions would create a hardship (especially with the 100 percent dividends received deduction provided by this bill). If it develops, however, that the differing definitions create a substantial hardship for certain groups subject to the penalty tax which cannot file consolidated returns (or obtain a 100-percent deduction for dividends received), the decision would have to be reconsidered and adjustments made to the extent possible.

(*c*)(*i*) *Test of control.*—In determining whether a controlled group of corporations exists, the bill draws a distinction between a parent-subsidiary controlled group and a brother-sister controlled group. In a parent-subsidiary controlled group one corporation, called a parent corporation, owns at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or at least 80 percent of the total value of all classes of stock, of one or more corporations called subsidiary corporations. The parent-subsidiary controlled group also includes corporations below the first tier subsidiary level which are 80-percent owned by the other corporations in the group. For example, if corporation A owns 80-percent of the stock of corporation B, and corporation B owns 80 percent of the stock of corporation C, corporations A, B, and C constitute a parent-subsidiary controlled group.

A brother-sister controlled group exists where a single individual, trust, or estate owns at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or at least 80 percent of the total value of all classes of stock, of each of two or more corporations.

In determining whether a corporation, or a single individual, trust, or estate, owns 80 percent of the value or voting power of the stock of a corporation, the stock of the corporation is considered not to include nonvoting preferred stock, which more closely approximates a debt obligation than an equity interest, and treasury stock, which, from the standpoint of ownership, constitutes unissued stock. Moreover, certain outstanding stock, although owned by separate persons, could, unless neutralized for purposes of determining control, be used by some owners as a means of divesting themselves of sufficient stock to avoid the application of this section without, as a practical matter, divesting themselves of the benefits of ownership of a corporation. Therefore, in determining whether a parent-subsidiary controlled group exists, stock of a subsidiary corporation owned by (1) individuals who are 5-percent shareholders of the parent corporation, (2) officers of the parent corporation, (3) employees of the subsidiary if the stock is subject to restrictions which favor the parent or subsidiary corporation, and (4) trusts which are part of a plan of deferred compensation for the benefit of the employees of the parent or subsidiary corporation, will not be treated as outstanding stock if the parent corporation owns 50 percent or more of the value or voting power of the stock of the subsidiary. In addition, in determining whether a brother-sister controlled group exists, stock of a corporation owned by (1) a trust forming a part of a stock bonus, pension, or profit-sharing plan for the benefit of the employees of the corporation, and (2) employees of the corporation if the stock is subject to conditions which run in favor of such corporation or the common owner and which substantially restrict or limit the employee's right to dispose of stock will not be treated as outstanding stock if the individual, estate, or trust owns

50 percent or more of the value or voting power of the stock of the corporation.

In determining whether a single individual, trust, or estate owns 80 percent of the value or voting power of the stock of a corporation, such individual, trust, or estate is, in addition to the stock owned directly, considered to own stock by virtue of certain relatively limited attribution rules. The first rule provides that an individual is considered to own stock owned by his spouse. However, it is recognized that in many cases a husband and wife may each own and operate their separate businesses. In order to prevent attribution in such cases, which may have the effect of denying separate surtax exemptions to each corporation, an individual is not considered to own stock owned by or for his spouse if (1) the individual does not directly own stock in the corporation in which his spouse owns stock, (2) the individual is not a director or employee of such corporation and does not take part in the management of such corporation, (3) not more than 50 percent of the gross income of the corporation is derived from rents, royalties, dividends, interest, and annuities, and (4) the stock of the corporation owned by the spouse is not at any time during the taxable year subject to conditions which substantially restrict or limit the spouse's right to dispose of such stock if such right runs in favor of the individual or his children who have not attained age 21 years.

The bill also provides limited attribution rules in cases involving other family relationships. Thus, an individual is always considered to own the stock owned by his children who have not attained age 21. However, an individual is considered to own the stock owned by his children who have attained age 21 and grandchildren only if such individual owns, directly or indirectly, more than 50 percent of the value or voting power of the stock in the corporation. Similarly, children who have not attained age 21 are considered to own the stock held by their parents, but children who have attained age 21 and grandchildren are considered to own the stock held by their parents or grandparents, respectively, only if the child or grandchild owns, directly or indirectly, more than 50 percent of the stock of the corporation. There is no attribution between brothers and sisters. Limited attribution rules are also provided in cases involving stock held by trusts, estates, and partnerships. Stock owned by a corporation, directly or indirectly, is considered to be owned proportionately by any shareholder owning a 5-percent or greater interest in the corporation. If an individual, estate, trust, or corporation owns an option to buy stock in a corporation, for purposes of ascertaining a controlled group, such "person" is deemed to own the stock covered by the option.

(c)(ii) *Method for determining existence of a controlled group of corporations.*—Determination of whether a controlled group of corporations exists is made once each year on December 31 by taking into account the stockownership of each person who owns stock in the corporation for the taxable year including such December 31. Although the determination of the corporations included within a parent-subsidiary controlled group, or a brother-sister controlled group, is made without regard to the type of corporation involved, provision is made to limit the reduction in the surtax exemption (or payment of the additional tax) to those corporations, referred to in the bill as component members, whose income tax is determined in whole or in part by reference to the normal and surtax rates. Thus, exempt organizations which do

not have unrelated business income, and foreign corporations which are subject to a flat rate tax on their income from sources within the United States, are not considered to be component members.

In order to limit reduction of surtax exemptions (or payment of the additional tax) to cases in which the common owner of the controlled group would otherwise derive the principal benefit from the allowance of the exemption, the bill excepts from the definition of component member those corporations which are members of the controlled group for less than one-half of the days in their taxable year which precede the applicable December 31 determination date.

In addition to corporations which meet the ownership tests described above on the applicable December 31 determination date, the term "component member" also includes a corporation whose stock is not owned by the parent corporation or common owner on such December 31 but was so owned one-half or more of the number of days in the corporation's taxable year which includes the applicable December 31. The inclusion of such "additional members" as component members prevents corporations whose stock is sold before the end of the year from obtaining the benefits of an extra surtax exemption in the year in which they leave the controlled group.

The bill also provides for cases where certain manufacturing corporations, in an effort to facilitate the retail distribution of products which they produce, enter into agreements with individuals whereby the manufacturer and the individual each contribute capital to a distributing corporation under a plan by which a portion of the compensation of the individual from the distributing corporation is applied toward the retirement of the stock held by the manufacturer. In most cases, franchised corporations of this type are, by definition, excluded from a controlled group due to the fact that the manufacturer owns less than 80 percent of the value and voting power of the stock of the distributing corporation. However, in some cases the corporate structures of these corporations are arranged in a manner which results in the parent corporation, or common owner, owning more than 80 percent of the vote, but not more than 80 percent of the value, of the stock of the distributing corporation.

Your committee agrees with the House that it would serve no useful purpose to cause these corporations to reorganize their corporate structures and has, therefore, excluded them from the definition of the term "component member" of a controlled group.

Finally, due to the nature of the business conducted by life insurance companies, and the fact that a life insurance company is not permitted to file a consolidated return other than with another life insurance company, a life insurance company is excluded from the definition of a "component member" of a controlled group unless the controlled group contains two or more life insurance companies, in which case the life insurance corporations are treated as component members with respect to each other since they may then elect to file a consolidated return with each other. A mutual insurance company, other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 821, which is included in a controlled group is also excluded from the definition of a "component member."

(c)(iii) *Privilege of groups to elect multiple surtax exemptions.*—The bill provides that the component members of a controlled group of

corporations may elect to have each component member of the controlled group claim a separate surtax exemption in lieu of having one surtax exemption apportioned among such members. However, if the component members of a controlled group so elect, the income tax on each member is increased by 6 percent on so much of its taxable income which does not exceed $25,000. For example, assume individual A is a common owner of a brother-sister controlled group of corporations consisting of corporations X and Y. Further assume that corporations X and Y each have taxable income of $35,000 and that they elect to have each member claim a separate surtax exemption and pay the additional 6 percent. By taking separate surtax exemptions, each corporation would pay a total tax of $7,000 on the first $25,000 of income (28 percent, consisting of a 22-percent normal tax and a 6-percent additional tax), and a tax of $4,800 on the remaining $10,000 of income (48 percent, consisting of a 22-percent normal tax and a 26-percent surtax), for a total tax on each corporation of $11,800. On the $70,000 combined income of the controlled group this would be a tax of $23,600. Alternatively, if the group did not make the election, the total tax on the controlled group would be $27,100 (22 percent of the first $25,000 of income and 48 percent on the remaining $45,000 of income). Under these circumstances, corporations X and Y presumably would choose separate surtax exemptions with the penalty tax, rather than apportioning a single surtax exemption between the component members of the controlled group.

For the component members of a controlled group to elect to claim multiple surtax exemptions, all component members of the group must join in the election. Such an election must be made within 3 years after the date when the income tax return is required to be filed for the taxable year of the component member of the controlled group whose taxable year ends first on or after the December 31 for which the election applies. An election once made may be terminated by the consent of the members, by the refusal of a new member of the controlled group to consent, by the filing of a consolidated return by any component members of the group, or by the termination of the group. Once an election is terminated, the bill provides that the group may not again elect multiple surtax exemptions until the expiration of 5 years. In the case of reorganizations involving groups of corporations some of which, for example, are, and some of which are not, prevented from filing new elections under the 5-year period, the Secretary of the Treasury is required to issue regulations which provide which group is to be treated as the predominant (or successor group) and hence which group's characteristics are to carry over.

(c)(iv) Disallowance of surtax exemption and accumulated earnings credit.—The bill makes two basic changes to present section 1551. The first change provides that if a corporation transfers property (other than money) directly *or indirectly* to a corporation which it controls, and such transferee corporation was created for the purpose of acquiring such property, or was not actively engaged in business at the time of such acquisition, the Secretary of the Treasury or his delegate may disallow the $25,000 exemption from surtax, or the $100,000 accumulated earnings credit, unless the transferee corporation establishes by the clear preponderance of the evidence that the securing of the exemption or credit was not a major purpose of the

transfer. As presently interpreted, existing law applies only to direct transfers of property other than money. The bill does not affect the transfer of money to a new corporation if the money is not used to indirectly acquire property from the shareholder making the transfer. Therefore, the amendment does not in any way inhibit the organization of new corporations with money transfers even though the corporation is organized for the purpose of acquiring a surtax exemption or accumulated earnings credit. However, the new corporation may be a component member of a controlled group in which case a single surtax exemption is allocated among the members of the group unless the group elects to file a multiple surtax exemption return.

The second change from present law extends the application of section 1551 to transfers of property (other than money) by an individual to a corporation which he and not more than four other individuals control. For purposes of determining whether the transferor is considered to be in control of the transferee corporation, the individual who makes the transfer, together with no more than four other individuals, must own at least 80 percent of the value or voting power of the stock in two or more corporations, one of which is the transferee corporation, and the same individuals must own more than 50 percent of the value or voting power of the stock in each corporation (only taking into account identical stock holdings) after the transfer. In determining ownership of stock, the constructive ownership rules for determining if a controlled group exists are applicable.

(c)(v) *Effective date.*—The amendment with respect to the limitation of the number of surtax exemptions allowable to component members of a controlled group and authority for component members to elect to file multiple surtax exemption returns is effective with respect to taxable years of corporations ending after December 31, 1963. The amendment made to section 1551 is effective with respect to transfers made after June 12, 1963.

(d) *Revenue effect.*—It is expected that this provision will increase revenues by about $35 million in a full year of operation.

46. Validity of tax liens against mortgagees, pledgees, and purchasers of motor vehicles (sec. 238 of the bill and secs. 6323(c) and 6324 of the code)

(a) *Present law.*—An assessed tax—income, estate or gift, excise, or withheld income or social security tax—if not paid within 10 days after notice and demand, constitutes a lien upon all of the property of the taxpayer, both real and personal. This lien follows the taxpayer's possessions, but it is valid as against a purchaser, mortgagee, or judgment creditor only if the notice of the tax lien has been filed prior to the sale or mortgage in the place designated by the State for the filing of such notices—usually the county recorder's office.

(b) *General reasons for provision.*—A prospective purchaser or mortgage lender with respect to real estate will check with the county recording office to ascertain whether there are any outstanding liens on the property. Ordinarily, liens against automobiles and trucks are not recorded in the county recorder's office. In many States any lien upon the automobile or truck is stated on the title. The one who wants to record a chattel mortgage, for example, upon an automobile must present his chattel mortgage and the certificate of title to the motor vehicle department of the State. Dealers in used automobiles,

therefore, rely upon these title certificates to determine whether or not there is any adverse lien on the automobile which they intend to purchase. However, the certificate of title does not show any Government tax lien. Thus, a dealer having unknowingly bought a car from a delinquent taxpayer may find that the car is seized by the Internal Revenue Service to satisfy the lien.

An automobile or truck dealer buying hundreds of used cars or trucks each year finds it difficult to follow the normal procedures—search of the records in the county recording office—with respect to each car which he wishes to buy. A similar situation exists with respect to the sale of stocks and bonds, which are ordinarily sold on the stock exchanges or over the counter without knowledge of any Federal tax lien which might exist with respect to such securities. For this reason, the law has long provided in the case of securities (sec. 6323(c)) that even though the Federal tax lien has been filed in the appropriate recorder's office, the lien will not be effective as against any mortgagee, pledgee, or purchaser of a security if at the time of the mortgage, pledge, or purchase the mortgagee, pledgee, or purchaser is without notice or knowledge of the existence of such lien. Your committee believes that a similar procedure with respect to autos and trucks would be appropriate.

(*c*) *General explanation of provision.*—This section of your committee's bill provides a similar protection for dealers and other persons purchasing or making loans upon motor vehicles as is now provided in the case of securities, so that the lien of the Federal Government will not be effective against a purchaser, mortgage lender or pledgee unless the purchaser, mortgage lender or pledgee has actual notice or knowledge of the existence of the Government's lien.

The definition of the motor vehicle to which this provision will apply is a vehicle (except a house trailer) registered for highway use under the laws of any State or foreign country.

(*c*)(*i*) *Effective date.*—The amendments made by this section apply only with respect to mortgages, pledges, and purchases made after the date of enactment of this bill.

(*d*) *Revenue effect.*—This provision is expected to result in a negligible loss of revenue.

C. HOUSE PROVISIONS DELETED BY YOUR COMMITTEE

1. Reimbursement of medical expenses in excess of such expenses (sec. 204 of the House bill)

(*a*) *Present law.*—Present law provides that gross income is not to include amounts received through accident or health insurance for medical expenses for personal injuries or sickness (secs. 104(a)(3) and 105(b) of the code).[1] At the same time medical expense deductions may be claimed (if they exceed the 3-percent floor) for accident or health insurance premium payments.

(*b*) *Reasons for deleting the House provision.*—Cases were called to the attention of the House Committee on Ways and Means where individuals have been covered by more than one accident or health insurance program. This occurs on occasion when the individual himself carries more than one policy, and occurs in other cases when

[1] An exception to this rule provides that amounts received under accident or health insurance policies are to be included in gross income to the extent they represent medical expense deductions allowed in previous years.

the individual may carry a policy and also his employer may provide for the payment of medical care either through an insurance policy or through self-insurance. In these cases, the employee may receive double payments with respect to the same expenses incurred with respect to a given injury or sickness. In these cases, the House provision would have treated the excess of the amounts received over the actual expenses incurred as income received by the individual.

Your committee is in agreement with the objective of the House provision. However, it has been called to the attention of your committee that the National Association of Insurance Commissioners this last December adopted a report on overinsurance recommending the enactment of legislation at the State level pertaining to this subject. The legislation recommended in effect would provide amendments to the uniform individual accident and sickness policy provisions of State law providing that health insurance benefits are to be prorated in the event of overinsurance among the carriers on the risk. This recommendation of NAIC is likely to lead to changes in State law within the next year or two in many, if not most, of the States. This in effect would eliminate the overinsurance with which the House bill provision is concerned. In view of this, your committee concluded that it would be better to remove the House provision from the bill and see if the problem of overinsurance is not met in the relatively near future by action by the various States. Your committee will review this matter within the next year or two and should implementing legislation not be acted upon by most of the States, it will then reconsider this provision. Your committee has concluded, however, that the problem is broader than merely the tax aspect and, therefore, that it would be more appropriately handled by the States than by amendment to the Internal Revenue Code.

2. Carrying charges (sec. 215(c) of the House bill)

(*a*) *Present law.*—Among the itemized deductions allowed taxpayers under present law is the deduction for interest payments. Administrative practice has long allowed as an interest deduction the portion of any carrying charges on installment purchases to the extent the interest element is stated separately. In 1954, Congress also provided that an interest deduction was to be available in the case of carrying charges stated separately even where the interest charged could not be ascertained directly. In such cases, the law provides that so much of the carrying charges as equal a 6-percent interest charge on the average unpaid balance under the contract is to be allowable as an interest deduction. This provision applies, however, only in the case of "personal property" purchased under an installment contract.

(*b*) *Reasons for deleting the House provision.*—Cases were called to the attention of the House Committee on Ways and Means where carrying charges are imposed with respect to tuition payments to various educational institutions. On the basis of this, the House bill would have extended the deduction for part of the carrying charge as interest in the case of carrying charges for services as well as personal property. Your committee would have no objection to extending this provision to cover service charges which are in the form of tuition payments; however, before this is extended to service charges, generally, your committee believes that there should be a further investigation of what might be covered under such a provision.

3. *Increase in basis with respect to certain foreign personal holding company holdings (sec. 216(j) of the House bill)*

(*a*) *Present law.*—Under present law the undistributed income of a foreign personal holding company is included in the income of the U.S. shareholders of the company and taxed to them. This treatment applies only where 50 percent or more in value of the outstanding stock of the corporation is owned directly or indirectly by five or fewer individuals who are citizens or residents of the United States. In addition, in the first year, 60 percent, and in subsequent years 50 percent, of the corporation's gross income must be "foreign personal holding company income." In general terms, this income consists of passive or investment forms of income, such as dividends, interest, etc. To a substantial degree, the same type of income is classified as foreign personal holding company income as is classified as personal holding company income in the case of domestic companies.

Stock in a foreign personal holding company differs from most other property in that, at the time of the death of the U.S. shareholder, it generally does not receive a new basis equal to its fair market value. Actually, the applicable rule in this case is that the basis of the stock at the time of the death of the decedent is to be the fair market value at that time or the basis of the stock in the hands of the decedent, whichever is lower.

For foreign corporations, including foreign personal holding companies, to participate in a tax-free reorganization it must be determined to the satisfaction of the Secretary of the Treasury that the exchange was not in the pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Of the two basic tax provisions on corporate liquidations, sections 331 and 333, foreign companies can use only section 331. Section 331 provides for the imposition of the regular capital gains tax on appreciation in the value of the stock. Section 333, which foreign corporations cannot use, provides that the accumulated earnings and profits of the corporation are to be taxed to the noncorporate shareholders as dividends and that capital gains are to be recognized on other appreciation in the stock only to the extent of the money and stock or securities acquired by the corporation after December 31, 1953, exceed the earnings and profits received as dividends. However, this provision also provides, in the case of assets acquired by the corporation before January 1, 1954, that no gain is to be recognized to the shareholder but that instead the shareholder is to receive the same basis for the assets received which he had for the stock (increased for gain recognized and decreased for money received).

(*b*) *Reasons for deleting the House provision.*—The House Committee on Ways and Means noted that the stock of a foreign personal holding company, when the shareholder dies, received much harsher treatment than is true of practically all other property included in the decedent's estate. Generally, property receives a new basis at a decedent's death equal to its fair market value, either at the time of the decedent's death or at the alternate valuation date 1 year later. Moreover, in the case of gifts where the donee carries over the basis of the donor, an increase in the basis (up to fair market value) is allowed to the donee with respect to any gift taxes paid on the property.

The House recognized that a relatively harsher treatment for the basis of the stock of these foreign personal holding companies is justified in order to discourage their use generally. However it was believed that it was appropriate to permit the same general type of adjustment to the basis as is presently permitted in the case of gifts; namely, to permit an increase in the basis of the stock of the foreign personal holding company equal to the death transfer tax imposed with respect to the appreciation in the value of the stock.

In view of the fact that the issue of a carryover of basis at date of death has not been dealt with by your committee in this bill, it concluded that it would be more appropriate to postpone consideration of this amendment until that broader topic was under consideration.

In addition, the House bill provided that these foreign personal holding companies were to be treated the same as domestic corporations for purposes of section 333 if the liquidation is completed shortly after the date of enactment of this bill. Since such companies are likely to have little if any accumulated earnings and profits, this in effect means that the shareholders would pay a capital gains tax on the appreciation of their stock in the corporation only to the extent they receive money, or stock or securities acquired after December 31, 1953, and that the basis of assets received in the liquidation is the basis of their stock in the corporation increased by the gain recognized. In such cases this property was to receive the same basis as it would if the shareholder died still holding the stock in the foreign personal holding company until this property had passed through one estate—the shareholder's or any transferee's.

Your committee has also decided not to include this aspect of the House provision in your committee's amendments. The same issue of the basis at date of death is involved here as where the stockholder dies still holding the stock of such a company.

4. Capital gains and losses (sec. 219 of the House bill)

(*a*) *Present law.*—Under present law, capital gains and losses are divided into two general classifications: short-term capital gains and losses and long-term capital gains and losses. The former are gains and losses on assets held for not more than 6 months and the latter are gains or losses on assets held for longer periods of time.

Gains and losses in each category are first offset against other gains or losses in the same category. Thus, there is determined "net," short-term gains or losses and "net" long-term gains or losses. Next, any net short-term gains are offset by net long-term losses or vice versa.

Net short-term gains in excess of net long-term losses are taxed to individuals or to corporations as ordinary income. In the case of net long-term gains in excess of net short-term losses, however, the tax treatment applicable to individuals and corporations differs somewhat. In the case of individuals, such a gain is included in the taxpayer's ordinary income and then reduced by a 50-percent deduction, or alternatively, the entire gain is omitted from the taxpayer's ordinary income base and a flat 25-percent tax paid with respect to this gain. In the case of corporations, there is no special 50-percent deduction. Instead, the corporation either includes the entire gain in its ordinary income, or alternatively, pays a tax of 25 percent on these capital gains.

The tax treatment of capital losses also differs somewhat between individuals and corporations. As previously indicated, any net short-term loss is first offset against any net long-term capital gain and vice versa. If there still remains an excess of capital losses (either short term or long term), these losses may be offset against ordinary income in the case of individuals but only to the extent of $1,000. If any net loss still remains, it may be carried forward for a period of up to 5 years as a short-term capital loss (whether such loss was in reality a long- or short-term loss) and as such in each of the years in succession first offset against net short-term capital gains, then against net long-term capital gains and finally against ordinary income to the extent of $1,000.

In the case of corporations, capital losses as in the case of individuals are first offset against gains in their own category (short term or long term) and then against gains in the other category. However, any remaining loss may not be offset against ordinary income to any extent, but it may be carried forward as a short-term loss and offset against short-term and long-term capital gains in each of the 5 succeeding taxable years.

The capital gain and loss treatment described above applies in the case of the sale or exchange of capital assets. In addition, certain other items are taxed in the same manner as capital gains. The principal category of assets treated in this manner are depreciable assets. Such assets, if the gains exceed the losses, are treated as capital gains; but, if the losses are in excess of the gains, they are treated as ordinary losses. Included with depreciable property for this purpose also are gains or losses from—

1. the sale of timber;
2. coal royalties;
3. livestock held by the taxpayer for draft, breeding, or dairy purposes if held by him for 12 months or more;
4. the sale of an unharvested crop sold in connection with the sale of the land.

Other types of items which are eligible for capital gain treatment are patent royalties received by the creator of the patent, certain lump-sum pension payments, and certain termination payments received by employees with more than 20 years employment. Income arising from the sale of stock acquired under a restricted stock option represents still another form of income accorded capital gains treatment under present law. In addition, this bill (sec. 228) provides capital gain treatment for iron ore royalties.

(b) *Reasons for deleting the House provision.*—The House bill would make three basic changes in the tax treatment of capital gains and losses. First, it would decrease from 50 to 40 percent, in the case of individuals, the proportion of the capital gain included in the tax base where the asset involved has been held for more than 2 years, and it would provide in such a case a maximum tax rate of 21 percent in lieu of the 25 percent; second, it would limit the more favorable capital gains treatment described above so that this treatment would not be made available with respect to transactions where the capital gains treatment under present law is made applicable to certain types of assets which are not capital assets; and, third, it would provide an indefinite carryover of unused losses in the case of individuals in lieu of the present 5-year limitation.

The Secretary of the Treasury in his testimony before your committee requested that the first two of the changes listed above not be made. He based this primarily on the fact that the administration in recommending lower capital gains tax rates had done so only as a part of a recommendation providing additional taxation on unrealized gains at death. Subsequently, this recommendation was modified to call for a carryover of the decedent's basis in such a case to the one receiving the property from the decedent. The House Committee on Ways and Means considered this latter proposal but rejected it at least in part on the grounds that there were technical problems which had not been satisfactorily worked out. In view of this, the Secretary of the Treasury in his testimony before your committee strongly urged that it not consider reducing the capital gains tax rates at this time.

In addition to the question raised by the Secretary of the Treasury as to whether capital gains tax rates should be lowered at the present time in view of the fact that other related structural changes are not now being made, questions arise as to the desirability of dividing the long-term capital gains group into two parts. Information submitted to your committee made it quite clear that this would substantially further complicate an already complex capital gains tax schedule. If the House provision had been adopted, not only would it be necessary to report separately three instead of two general categories of capital gains, but it would also be necessary to subdivide the proposed class A and class B gains between those coming under section 1231 and those which do not. Although gains from the sale of such assets result in capital gains where there is a gain from all such assets taken together, nevertheless, if there is a loss from the aggregate of these transactions with respect to these assets, they give rise to ordinary gain or loss. In addition, it is necessary on this schedule to account for the "recapture" of ordinary income provided generally for tangible personal property in the Revenue Act of 1962 and the somewhat different "recapture" rule provided in this bill with respect to real estate. As a result of the interrelationship of these factors, your committee concluded that it would be better not to further complicate this schedule at the present time by this further breakdown of what are presently long-term capital gains or losses for individuals.

Your committee also was concerned about the capital gains provision of the House bill because the benefit from this provision would have been largely concentrated in the very highest income brackets. The concentration of capital gains in the higher income levels in fact is a major factor accounting for the effective rates in the highest brackets being substantially below the rates shown in the tax rate schedule. Table 11 shows, for example, that, although those with incomes over $200,000 represent a small fraction of 1 percent of all the taxpayers, nevertheless they receive 16 percent of all capital gains. This is about the same percentage of capital gains received by the 58 percent of all taxpayers having incomes below $5,000. Those with incomes of $100,000 or over, although representing only 0.04 of 1 percent of all taxpayers, nevertheless receive 24 percent of all capital gains.

The effect of reducing the capital gains inclusion factor, or alternative rate, because of this concentration of these gains in the higher income classes would, of necessity, have meant that most of this relief would have gone to those with the highest income levels. This

is shown in table 12, which presents the overall distributional effects of the House and your committee's bill in detail for incomes over $50,000. This table indicates that, although the capital gains reduction in the House bill as a percentage of the present total tax amounted to only 0.7 of 1 percent, nevertheless the tax reduction which this would have accorded those with incomes between $100,000 and $200,000 would have been 3.4 percent; and this percentage would have risen to 7.4 percent for those with incomes of $1 million or over. This can be compared with the capital gains tax reduction accorded those with incomes of $3,000 and under of 0.3 of 1 percent. Your committee did not believe that a reduction of this type was justified in view of the overall distribution of reductions in this bill.

TABLE 11.—*Capital gains, by income levels*

Returns with adjusted gross income of—	Comprise this percentage of all taxpayers—	But receive this percentage of all capital gains
$200,000 and over	0.0096 of 1 percent	16
$100,000 and over	0.04 of 1 percent	24
$50,000 and over	0.2 of 1 percent	35
$10,000 and over	8.7 percent	69
Less than $5,000	57.8 percent	17

Source: Treasury Department.

TABLE 12.—*Overall distributional effects of the House bill (including capital gains changes) and the Finance Committee bill (which retains present law capital gains treatment)*

Adjusted gross income class (in thousands of dollars)	Total tax reduction as percentage of present tax		Capital gains tax reduction in House bill as percentage of total present tax
	House bill	Finance Committee bill	
0 to 3	38.6	38.6	0.3
3 to 5	26.5	27.3	.3
5 to 10	20.1	20.9	.2
10 to 20	16.9	17.3	.4
20 to 50	16.0	15.8	1.0
50 to 100	13.5	12.3	2.0
100 to 200	12.2	9.7	3.4
200 to 500	12.4	8.1	5.0
500 to 1,000	12.1	5.7	7.2
1,000 and over	12.0	5.6	7.4
Total	18.9	19.1	.7

Source: Treasury Department.

It should be noted that the great bulk of capital gains is accounted for by taxpayers by including 50 percent of the gain in income rather than by subjecting these gains to a separate flat 25 percent tax. It has been estimated that most of the capital gains fall in the former category where 50 percent is included in the ordinary income tax base. As a result, the regular rate reductions provided in this bill, which range from 30 percent for those in the bottom brackets to 23 percent for those at the top, will also be applicable in the case of these capital gains. Thus, even without any special tax treatment for capital gains, a substantial reduction in tax is provided by your committee's bill with respect to these gains.

INDIVIDUAL VIEWS OF SENATOR PAUL H. DOUGLAS

Good Features of the Bill

There are many good features in the present tax bill, H.R. 8363. Among these are (1) the fact of tax reduction itself which will stimulate demand, production, and employment; (2) the minimum standard deduction of $300 per taxpayer plus $100 for each family dependent (this with the per capita exemption of $600 means that families of four whose yearly incomes are less than $3,000 will be exempted from taxation—as they should be—instead of those under $2,666 as is now the case, i.e., $2,400 plus the 10 percent standard deduction); (3) the shifting of the corporation tax collection period from the present delayed system to roughly the same basis as taxes are now collected from individuals; (4) the repeal of the 4 percent dividend credit against taxes actually owed, and certain other features as well; and (5) the elimination by the Finance Committee of the reduction in the capital gains tax.

The capital gains loophole is already the largest loophole in our tax system. Between $5 and $6 billion a year are lost because of this provision. The bill as it came from the House of Representatives would have widened and deepened this hugh loophole by reducing the rate on long-term capital gains from 50 to 40 percent, subject to a maximum of 21 percent instead of the present inadequate rate of 25 percent. This was eliminated by a narrow margin in the committee. There is grave danger that this reduction will be restored in the conference committee. This danger will be reduced if the Senate itself, by a decisive vote, approves the action of the Finance Committee in eliminating this section from the House bill. This, in my judgment, should occur early in the Senate proceedings.

There are some grave defects in the bill as presented which I believe the Senate should correct. The bill also fails to effect much needed reforms in our tax system which are long overdue and for which there will not be another opportunity for some years.

Generally speaking, our present tax structure is riddled with injustices and inequities. There are so many loopholes that 20 people with incomes over $500,000 in 1959 paid absolutely no taxes at all while the average amount of taxes actually paid by all those with incomes of $5 million or more came to slightly less than 25 percent instead of the 90 percent they would theoretically be expected to pay. This is less than the amount which a typical American family with a taxable income of $12,000 derived from wages and salaries would be expected to pay or, because of collection at the source, would actually pay.

If we could close the various loopholes and "truckholes" in the Revenue Act, we could reduce the individual income tax rate from the present scale of 20 to 91 percent to a range of from 10 percent as the

minimum to a maximum of 50 percent. In doing so we would raise as much revenue as we do with our apparently high rates which, as a matter of fact, are not paid by the vast majority of those in the upper income tax brackets. In this connection it is appropriate to quote a salient passage from Philip M. Stern's forthcoming book entitled "The Great Treasury Raid" in which that keen student of our tax system, comments as follows:

> For a raid of its magnitude, the time (high noon) and setting (the U.S. Treasury, a stone's throw from the White House) showed a breathtaking boldness of design and planning. From out of nowhere, it seemed, they appeared—old people and young, rich and poor, an oil millionaire here, a factory worker there, a real estate tycoon, a working mother, several well-known movie stars, some corporation presidents, even the chairman of a powerful congressional committee. It was a mixed lot, all right, that converged on the Treasury Building that high noon. Into the building they strolled, gloriously nonchalant. No one stopped them; not a guard looked up to question them. Quickly and quietly they found their way to the vaults; opened them noiselessly with the special passkeys each had brought with him. Like clockwork, with split-second timing, each went to his appointed spot, picked up a bag and walked out as calmly as he had entered. At the exits the guards sat motionless. At precisely 12:04 it was all over. Each of the "visitors" had vanished into thin air.
>
> So had $40 billion from the U.S. Treasury.

The administration initially made a partial but somewhat ineffectual effort at tax reform. But when most of its proposals were rejected by the House Ways and Means Committee, they ceased to fight with any vigor except on two matters, namely (*a*) the abolition of the unjust 4 percent dividend credit inserted under the Eisenhower administration in 1954, and (*b*) the removal of the reduction in the capital gains tax. Neither of these features is in the present bill, and I hope we can hold these gains.

In other words, the great mass of citizens, primarily in the lower income brackets, have to pay high taxes because the laws have been so shaped that a minority are able, by avoidance and evasion and counseled by highly paid and able tax attorneys, to take advantage of every twisting and turning of the laws. I repeat, if we could plug the loopholes and "truckholes," we could collect the same total amount of revenue with half of the present tax rates. Our failure to do so means that the present unfair and unjust system continues. As a consequence, the present bill, except for the unjustifiable provision with respect to utilities, remains neutral with respect to remedying the great injustices in the tax system. Its failures are not, for the most part, acts of commission, but rather acts of omission. Because of the stimulus which the tax cut itself should bring to the economy, there are many like myself who can therefore support the bill because its stimulating features are good, but in the meantime express dissatisfaction over the failure of the House and the Senate committees to remedy many of the well-known and major loopholes in

the tax system. To us, tax reform is as important as tax reduction. But this bill has a great deal of reduction but very little reform.

The major loopholes in the system are (1) the present provisions for capital gains—the biggest loophole of them all. Huge amounts of ordinary income are taxed at a special lower rate, and other gains are not taxed at all, as in the case of the failure to tax capital gains at death.

The abuses involved in the oil depletion allowance, the writeoff of intangible drilling and development costs in the first year, and the ability of the oil industry to count royalties abroad as a tax payment instead of a deduction of expenses, is another area of grave abuse.

There are additional areas such as the unlimited charitable deduction, which is responsible for people with millions of dollars of income escaping any Federal taxation at all, and such other well-known loopholes as stock options, collapsible corporations, and corporate spin-offs, which mean that the favored few pay a smaller proportion of their income in taxes than the many with modest incomes.

Furthermore, State and local systems of taxation are highly regressive. That is to say, those with low incomes pay a higher proportion of their incomes in taxes than do those with high incomes. The progressive features of the Federal system should offset this so that the overall tax system of the country—Federal, State, and local—is at least proportional. But the fact that the Federal system is riddled with loopholes which favor high income groups, plus the fact that about $13 billion a year is collected in excise or sales taxes at the Federal level, means that even the Federal system has very little, if any, progression in it, and the total tax system is probably somewhat regressive in nature. The present bill fails to correct this situation. The repeal of some of the most onerous and least justifiable of the excise taxes could help to make our tax system more fair.

I therefore hope that we may take the following action to improve this bill:

First. We should try to get the Senate, by an overwhelming vote, to uphold the Finance Committee's action in knocking out the new capital gains loophole. This would strengthen the Senate's position in the conference committee. Otherwise, the capital gains provision in the tax law may end up worse than under present law. This should be a minimum position and it would certainly help if the Senate would also try to do something in the area of capital gains at death.

Second. The Senate should eliminate that feature of the tax bill which has no rightful place in a tax bill, namely, section 202(e) which states that the Federal regulatory commissions need not pass through the tax savings from the investment credit to the consumer. Apart from its lack of merit, this is basically a regulatory rather than a tax matter and really has no place in this bill.

Third. We should retain in the law the Long amendment of 1962 with respect to the investment credit. Corporations which invest $100 in investment reduce their taxes by $7. This is the equivalent of a $14 before-tax deduction. The Long amendment in 1962 said that a corporation could not depreciate more than $93 worth of investment, but the bill before us will allow the full depreciation of the asset even though its actual cost was less because of the investment credit. The elimination of the Long amendment will ultimately cost about $600

million a year and hence raise the investment credit to about 11 percent.

Fourth. The present provisions in the law with respect to stock options should be greatly modified and the provision in the bill with respect to the amount of term insurance which a corporation can purchase for its employees should be reduced at least to the House figure.

Fifth. We should try to repeal some of the retail excise taxes, such as those on leather goods, women's handbags, inexpensive jewelry, cosmetics, and furs, but we should place a limit of $100 on the amount which is free of tax so that we do not reduce the tax on luxury expenditures.

Sixth. Furthermore, we should certainly try to do much more than is done in the bill with respect to the oil depletion allowance. As a minimum, we should prohibit excess depletion from being used to offset income from sources other than direct oil production. This was proposed by Senator Williams in the committee, accepted twice, but finally considerably watered down at the last moment.

We should also consider an amendment to the depletion allowance which, while retaining depletion for the small producer who does take considerable risks, reduces the depletion allowance for those whose income from gas and oil is between $1 and $5 million to 21 percent, and for those with incomes from gas and oil in excess of $5 million to 15 percent. This would save $400 million a year.

Seventh. We should also not undo the minor progress made with respect to travel and entertainment allowance loopholes in 1962. We should not finally adopt some of the provisions either in the bill or which have been proposed to the bill.

Eighth and finally. We should consider the equity of the rate structure itself. The present bill grants about $2½ billion in tax reductions to corporations and over $9 billion to individuals. The latter is done by reducing the rates; namely, from the present 20 to 91 percent to a figure of 14 to 70 percent.

In addition, the bill splits the rates for the first bracket and gives a new minimum standard deduction. These last two features redeem the inequities in the nature of the personal tax reduction so that there is some degree of equity. However, there is neither a strong case nor any equity considerations involved in reducing corporate taxes by $2½ billion. Since 1954, corporations have had tax reductions of almost $5 billion through the 1954 fast tax writeoff and depreciation provisions, and the 1962 investment credit, and revision of Bulletin F. This bill grants another $2½ billion to corporations while individuals receive some reduction for the first time.

Because of this, it would be well to use some of the corporate reduction to increase the minimum standard deduction or to increase the $600 exemption. Personally, I would propose taking at least $1 billion from the corporate reduction and using the funds to increase the personal income tax reduction. This would be more equitable, would make the tax system more just, and, in my judgment, would give a much stronger stimulus to the economy than the present method.

Moreover, the Senate and the Congress should give serious consideration to simplifying the tax structure and making it more equitable

by the simple process of repealing most of the existing loopholes and truckholes in the tax laws and then using the gain in revenue to bring a drastic reduction in income tax rates. By closing most of the present loopholes, the tax rates could be reduced from the present level of 20 to 91 percent to a new level of about half that amount, or from 10 to 50 percent. This would simplify the tax structure, make it more just and equitable, and improve its enforcement, while benefiting the great mass of Americans who pay their taxes and who do not either avoid or evade them. The longer we put off tax reforms the more unjust our system becomes. The time to act is now.

PAUL H. DOUGLAS.

INDIVIDUAL VIEWS OF SENATOR RIBICOFF

This tax bill will have my vote, but not my unqualified approval.

Many unwise provisions have been included, some desirable provisions have been omitted, and the bill as a whole will not achieve all of the results that have been claimed for it.

Rate reduction and reform are the principal needs to which this bill should be directed. It achieves rate reduction. It does not achieve reform.

Unfortunately, the public has been largely unaware that the issues in this bill included anything more than simple rate reduction. To judge from the general reaction to the bill, one would think it contained a single provision saying, "Taxes shall be reduced by $11 billion." The fact is the bill containes more than 300 pages of detailed provisions, making a great number of changes in 37 separate areas of the Internal Revenue Code, in addition to the provisions making reductions in tax rates. In a few instances, these so-called structural changes do make modest reforms. But many needed reforms have not been made, and many of the changes in the bill are the opposite of reform: they are special preferences for a few taxpayers.

I do not agree that we should benefit—

utility companies by prohibiting the "flowthrough" of the investment credit to consumers;

department stores by allowing special tax treatment of revolving credit sales;

iron ore companies by providing capital gain treatment for certain royalty payments;

companies with foreign subsidiaries by permitting a 10-year carryforward for expropriation losses;

insurance companies by giving them capital gain treatment of bond discounts in certain situations; and

purchasers of new equipment by doubling the benefit of the investment credit.

These provisions are all included in the bill. The revenue loss for 1964 is estimated at $305 million.

Left out of the bill are provisions to reduce depletion allowances, end the immediate writeoff of intangible drilling and development costs for oil and gas, and abolish the preferential treatment of stock options. These provisions would have prevented a revenue loss in 1964 of $1,150 million.

These sums of money would more than pay for two other provisions which I believe should be included in this bill. These provisions would benefit the national interest and help millions of individuals. I will offer them as amendments on the Senate floor.

My principal amendment provides an income tax credit for college costs. The amendment provides a credit based on the first $1,500 of tuition, fees, books, and supplies at an institution of higher education. The credit is available to anyone who pays these costs—parents, students, or any other person who wants to pay for the

education of a deserving boy or girl. The credit is 75 percent of the first $200, 25 percent of the next $300, and 10 percent of the next $1,000. The credit is reduced by 1 percent of the amount by which the taxpayer's adjusted gross income exceeds $25,000—in other words, reduced $50 for each $5,000 of income above $25,000.

The financial burdens of high college costs are just as entitled to be eased through tax relief as medical expenses and casualty losses. These college costs hit middle income and lower middle income families with a serious impact. The man earning $8,000, $10,000, or $15,000 is generally not eligible for scholarship or loan funds for his son or daughter, and he faces a heavy burden in paying $2,000, $1,000, or even $500 for college costs.

One of the premises of this bill is that incentives should be given to capital investment. Yet there is no better form of capital investment we can make than investment in education. The investment credit in the 1962 tax bill and the revised depreciation guidelines provide over $2 billion in tax relief for investment in machinery. The pending bill provides millions more for this purpose. I believe we should invest in the education of our youth. In the last analysis, trained minds, not just new machines, will insure the success of this Nation.

Four main objections have been raised against this proposal:

1. It is claimed the amendment helps the wealthy. The fact is the credit benefits the $30,000 man less than the $5,000 man, and does not benefit the $60,000 man at all. Under this amendment, 91 percent of the dollar benefit goes to families with incomes below $20,000, 63 percent to families with incomes below $10,000.

2. It is claimed the amendment discriminates against the poor. The fact is the credit operates exactly like all other tax relief provisions of the Internal Revenue Code: it is available only to those who pay a tax. The medical deduction is not used by nontaxpayers, yet few would oppose it on this ground.

Those in the very low income groups who pay no taxes need a sound program of student aid including scholarships. I am for such a program. It is needed in addition to tax relief for the middle-income families. These are not alterntives. They are both necessities.

3. It is claimed the amendment favors the high tuition colleges, most of which are private colleges. The fact is the amendment favors the low tuition colleges, most of which are public colleges. The credit on a $200 expense is $150. That's 75 percent. The credit on a $1,000 expense is $275. That's only 27 percent. Even where a college charges no tuition, the expense of fees, books, and supplies invariably totals $200 or more.

4. It is claimed all the tax benefit will be absorbed in tuition increases. The fact is that tuitions go up whether tax relief is granted or not. Furthermore, any colleges that want to raise tuition because they know parents have some extra money will take advantage of the rate reductions in this bill. They can absorb the tax dollars that come from rate reductions, whether or not my amendment is added to the bill. Finally, the amendment provides only a 10-percent credit on expenses over $500, so every added $100 of tuition over $500 results in only a $10 saving to the parent—scarcely an incentive to the college.

For years proposals similar to this one have regularly been introduced by many Members of the Senate. I believe there should be an

opportunity for every Senator to vote on this proposal. I intend to see that this opportunity is provided.

My second amendment permits accelerated deductions of expenses for air and water pollution control equipment. If we are ever to make substantial progress in combating air and water pollution, we must recognize that private industry has a major part to play. But playing that part costs money. Since these expenditures are for a public purpose, the public should assume part of the burden through tax relief.

Industry needs financial encouragement to speed the acquisition of this equipment. This equipment produces no revenue to the company that installs it. Yet the Internal Revenue Code and many new amendments provided in this bill provide billions in tax relief for expenditures that are revenue producing. In fact, the Treasury Department last year proposed that fast tax writeoffs be provided for all equipment purchased for research and development expenditures which are clearly revenue producing.

When we are providing hundreds of millions to establish air and water pollution control programs, we should not overlook the need to help industry make the purchases of pollution control equipment which can make the difference between success or failure in cleaning up our environment.

Finally, I must express a word of caution concerning the claims that have been made for this bill as a whole. It can legitimately be called a needed stimulant to an economy that is not operating at full capacity. But it cannot and should not be expected, in and of itself, to spur that economy to full capacity or to solve many of the difficult problems that have been preventing our economy from reaching full capacity. Chief among these is unemployment and while this bill will help create new jobs, I do not believe it will solve the basic problem of structural unemployment. Economists with views as divergent as Leon Keyserling and Roger Freeman agreed on this point in testimony before the committee.

"I doubt that tax reduction can make a major impact on our present type of unemployment," said Freeman. "Even well-designed tax reduction cannot cope with a large portion of the unemployment problem," said Keyserling.

This joint warning should be well heeded. As we enact this tax cut bill, let us not delude ourselves or the country into thinking that it is a cure-all for our problems, especially for our unemployment problem.

We should pass this bill despite its imperfections. Taxes are too high and do act as a deterrent to individual initiative. This bill will be of benefit to all segments of our society and will be helpful to the economy. But we must continually strive toward the goals that remain: tax reform, a meaningful reduction in unemployment, and a fully productive economy.

ABRAHAM RIBICOFF.

27-814—64——12

MINORITY VIEWS OF SENATOR ALBERT GORE

Position in Brief

On balance, in the light of its design and consequences, and in view of its scope and magnitude, this is one of the most important and most ill-advised bills ever to come before the Congress for serious consideration.

Born of ineptitude in economic forecasting, sired by political considerations, and nurtured by the greed of special interests, it creates more inequity in many respects and bears no resemblance to true tax reform. Favoritism in tax law, furthered by H.R. 8363, threatens to erode our economic, political, and social structure.

Specifically, this bill—

(1) Is the embodiment of fiscal folly. While it is generally recognized, and I am no exception, that a balnced budget is not necessary or even desirable in every year, and in all circumstances, debt and deficit cannot be ignored indefinitely. After 3 years of unprecedented prosperity, expansion, and growth, and with nearly all the important economic indicators pointing upward, we certainly should not seek deliberately further to increase debt and deficit and to impair, for all foreseeable time our capacity to meet pressing public problems by a drastic reduction of governmental revenue.

(2) Provides no solution to our economic or social problems. The vast, unfulfilled economic needs of our society lie in the public sector—better housing for low-income groups, better mass transit systems, better educational facilities at all levels, better highways, more and better hospitals and nursing homes, more clean drinking and industrial water. The private sector of our economy is the wellspring of our continued prosperity, but this sector is fat with unused productive capacity. The unemployed and those burdened by poverty need specialized assistance in overcoming specific problems. Those who are so enamored of aggregates and macroeconomics fail to recognize that specific solutions are needed for very specific and pointed problems. The war on poverty is thus far but a skirmish of words—we need a pitched battle, with live and heavy ammunition, aimed at specific targets. Necessary programs require more, not less, revenue.

(3) Would provide the wrong type of tax cut, even if a large reduction in revenues were justified at this time. The tax reduction provided by this bill for the already very rich, through both a drastic reduction in high bracket personal income rates and a cut in corporate rates is unconscionable. Equity aside, sound economic theory is violated. If any shortage exists in our economy in the private sector, it is to be found in an absence of broadly based purchasing power. An equitable solution by way of revenue reduction would dictate a tax cut which would restore some of the prewar purchasing power which has, ever since that

time, been withheld. An increase in the personal exemption, with possible consideration being given to the restoration of some preferential treatment for earned income would be not only more equitable but more defensible from a purely economic standpoint. The reconcentration of wealth directly attributable to the tax cuts as well as indirectly realized from increased interest payments—acting as transfer payments—which will be stepped up by virtue of the built-in deficits created or increased by this bill, poses grave dangers. Political democracy can hardly survive without economic democracy.

RATE REDUCTION

GENERAL

The subject bill represents one of the most flagrant, obvious, and dangerous attacks of the past 35 years on the ideals, purposes, and underlying machinery of our economic democracy. Economic democracy is one of the hallmarks of our society, without which political democracy, social progress, and national purpose would soon cease to be.

In the name of equity this frontal attack is being made on the graduated income tax. The result will be a reconcentration of income and wealth in the 1929 pattern—an increased inequity.

In the name of economic expansion and employment opportunities, this bill would increase the already high liquidity of corporations, resulting not in increased jobs, but in increased automation, increased outflow of investment funds and jobs to Europe, and increased dividends to line the pockets of the rich and very rich.

In the name of social justice—the war on poverty, ignorance, disease, the hopelessness of those who dwell in city slums or in areas of worked out agricultural and mineral production—this bill would put the Federal Government in a fiscal straitjacket, denying to the Government the revenues required for any successful assault on poverty and its ugly bulwarks.

In the name of tax reform, this bill would, for at least a generation, dull the spur for real reform. Professed liberals will fain surprise in future wars for reform when they find themselves deserted by some of their current allies, even as the armies of David withdrew from Bathsheba's husband, leaving him naked and alone before the walls.

If the pattern of this bill is followed, we will likely witness, within the next few years, a worsening of our economy. We may well find ourselves repeating the 1954–57 pattern of nonsustainable productive capacity and increased unemployment.

Government—society organized for political purposes—does not exist for economic reasons alone, and I would never equate economic prosperity with the good life. But a society does not long live when it supports a politicoeconomic system which gives to the man who has one loaf two, while withholding from the man who has half a loaf or none.

Ideals and attitudes are as important as economics. The cynicism of some of the backers of this bill will be long remembered by those who are now without effective representation in Washington. Propaganda, like morphine, soon wears off. It will not be long before the majority of our citizenry awake to the realization of reality and know

that their bag is still empty and there never really was a snipe in the woods at all.

We decry and deplore waste and inefficiency in Government spending—and rightly so. But those who are so enamored of aggregates and mesmerized by macroeconomic manipulation in the private sector seem to assume that they have discovered in a tax cut economic perpetual motion—without waste, without inefficiency, without friction. All we need to do, we are told, is to release the "brake" of taxation on the economy and the private sector will expand in exactly the right ways to cure unemployment, without inflation of course, and will with perfect equity insure the good life for all, without Government interference or activity.

And all this without error in decisionmaking. Where was Adam Smith's "unseen hand" when the Edsel automobile was stillborn?

The theory behind a tax cut of this type and magnitude, under conditions existing today, will not stand close examination. Indeed, it is difficult to pin down the theory upon which some base their support for this bill.

Regardless of theory, the practical results of a tax cut of the type proposed will be diametrically opposed to the ostensible goals of many of its proponents. The implementation of this fiscal folly is a reckless gamble with our entire national economy.

In theory, assuming we are all Keynesians, and assuming further that conditions today fit the situation envisioned by Lord Keynes when he tried to adapt economic theory to fit the world stagnation of the late 1920's and early 1930's, a deficit will inflate the economy. This deficit can be achieved by increased spending or decreased revenues. But conditions are far different in these days of dynamic expansion.

The result of this bill will be to transfer yet another large slice of national production and wealth from those who produce wealth to those who parasitically participate in its enjoyment.

II. THE ADMINISTRATION POSITION

From the early and recurring rumors of a tax cut which gained wide circulation in the early fall of 1962 to the present time, it has been difficult to understand from statements issued by spokesmen for the administration the specific purposes of this proposed tax reduction.

At times this bill seems to have been regarded as a vehicle for long-range tax reform.

At other times it appers to have been sold as a hedge against more or less imminent recession.

At still other items, it appears to be straight Keynesian deficit financing for the avoidance of low-level equilibrium in the economy.

Under current conditions, and in the form in which this bill now exists. This legislation makes a mockery of any and all these purported positions.

The late President Kennedy in his tax message of January 24, 1963, stated:

> My recommendation for early revision of our tax structure is not motivated by any threat of imminent recession * * *.

But by March, when some of the indicators seemed to hang a bit, he seemed to have something else in mind, telling us:

> If we don't have the tax cut, it substantially, in my opinion, increases the chance of a recession * * *.

By May it became apparent that 1963 would be a good business year, and Secretary Dillon came back to the original theme. On May 7, 1963, the Secretary of the Treasury—a consistent follower of Republican theory and doctrine—told the Chamber of Commerce of New York:

> Above all, it must be borne in mind that the President's program is not intended—and is not designed—merely as a quick and temporary shelter against recession. It was designed—and has always been intended—as a permanent program to raise our long term rate of overall economic growth.

But again, the late President Kennedy on September 9 expressed concern that without a tax cut in 1963 "we may move into a period of economic downturn."

Meanwhile, Dr. Heller was working the Keynesian theme. I must say he has stuck pretty closely to this line, which he set out most explicitly in an article which appeared in November 1962 in Nation's Business:

HOW CUT WOULD SPUR GROWTH

> The U.S. economy has consistently fallen short of its employment, production, income, and profits goals in the past 5 years. A sizable cut in tax liabilities both of households and businesses throughout the Nation would push the economy toward more robust activity in three main ways—ways which would bring business stronger markets, expanded investment opportunities and healthier profits:
>
> 1. Tax reduction would increase the disposable income—the take-home pay of consumers. Careful analysis of past experience indicates that consumers consistently spend from 92 to 94 percent of their disposable income. History also shows that when this income is increased, a high proportion of the increase is promptly spent.
>
> When consumers spend this income, markets strengthen, production rises, new jobs are created, and income and profits rise accordingly. This creates added cycles of private spending. Boosted spending and income results in what economists call the "multiplier effect." It produces an increase in gross national product of perhaps two or three times the original reduction in taxes. Gross national product, the total output of goods and services, is, of course, a major indicator of growth.
>
> 2. By strengthening sales and pushing output closer to capacity, tax reduction spurs investment in inventories and in new equipment and new plants. This impact on investment in productive capacity is called the "accelerator effect." The increased production of capital goods expands gross national product, stimulates further consumption and increases profits. It reduces the deterrent effect of excess capacity,

which has tended to discourage investment in productive facilities during the past 5 years or so.

3. Reducing personal and corporate taxes raises profit margins for businessmen and enlarges the supply of internal business funds available for investment. Tax reduction thus strengthens the incentive to invest in two ways: Businessmen have money available to undertake the risks of new investment. And there is the prospect of larger after-tax returns to be earned on new productive facilities.

So, tax reduction would help business directly by reducing the tax load on business enterprise and indirectly by stimulating demand for both consumer goods and capital goods, thereby boosting the volume of sales and output. Indeed, tax cuts achieve their stimulating effect mainly by inducing business to employ, produce, and innovate.

President Johnson stated in his Economic Report, "The tax cut will give a sustained lift, year in and year out to the American economy." This would seem to indicate that this action is in the nature of some sort of permanent reform.

Its proponents claim this bill will:

1. Stimulate economic growth.
2. Balance the budget.
3. Relieve unemployment.
4. Solve the balance-of-payments problem.
5. Avoid inflation.
6. Promote tax equity.

This is just what the doctor ordered, and it all comes in one little pill which causes the happy patient no pain whatsoever.

III. ECONOMIC EXPANSION

It is claimed that this bill would stimulate the economy in two ways. First, consumers, having more money to spend by virtue of a tax cut, will spend more and thus create additional demand. Second, investors will have more money to invest by virtue of being able to show a better rate of return.

But these are only the first steps. At that point the "multiplier" and the "accelerator" take over and we bootstrap ourselves up to the point where—within a relatively short time, of course—we increase our gross national product by at least three times the amount of the tax cut.

If there were a shortage of funds for investment, a tax cut for corporations might induce more investment. If there were a shortage of spendable personal income, a tax cut for consumers might create increased consumer demand.

But do these conditions prevail? Not at all. Corporations are highly liquid and rarely need to go to the capital markets for outside money. Corporations sold only about $1 billion of new common stock last year. Personal income, although poorly distributed, continues to rise. The irony of the tax cut is that it would give increased spending and purchasing power to those who need it least and who would use it sparingly. The man on the bottom of the poverty pile pays no income taxes now. He needs income, not a tax cut.

Now, what is the likelihood of complete, or nearly complete, and prompt, spending of increased personal income? The prospects are not good.

Already personal savings are high. Increased take-home pay by way of a tax cut is apt to increase savings, at least for several months. Of course, the man who is out of a job, or the man who is trying to get by on such a small income that he has no tax to pay, would spend more money if he could get it, but this bill does nothing for him.

Savings are up 25 percent in the past 3 years. Secretary Dillon, himself, in an interview reported in Banking for May 1963, said, "At present when our economy is not operating at full speed, it is characterized by what one might call an excess of savings."

If there is now an "excess of savings," why would it be thought that marginal income would be largely spent rather than saved?

I am not the only one who questions this aspect of this bill. As long ago as February 26, 1963, an article appeared in the Wall Street Journal emphasizing this point. Here are two paragraphs from that article:

> To many economists, the savings rise suggests that a tax cut to spur consumer spending—as proposed by the Kennedy administration—may not be particularly effective, at least in the middle and upper income brackets. If consumer demand continues to lag, they argue, a considerable part of extra income from reduced taxes would go into savings, rather than be spent.
>
> "The theory behind the tax cut idea is that it will stimulate demand," says J. Walter Thompson's Mr. Johnson. "But the savings accumulation suggests this may not happen." John R. Bunting, vice president of the Philadelphia Federal Reserve Bank, expresses "concern" that income consumers may receive through lower taxes "will be siphoned out of the spending stream" into more savings.

There is now no shortage of investment funds in the corporate structure. On the other hand, corporations are highly liquid. Profits are rising, and cash flows are rising even faster.

I do not see how hard statistics can be overlooked. In 1963, corporate cash flows, after allowing for taxes, amounted to about $60 billion. After record dividend payments, this left well over $40 billion in the hands of corporate management. Investment in plant and equipment amounted to only about $39 billion. Would anyone logically think that increasing cash flows by way of a tax cut would materially increase investment in plant and equipment—given these conditions?

We now have further statistical proof that a tax cut will induce little in the way of increased plant and equipment expenditures.

According to Dr. Heller, in addressing the Printing Industries of Metropolitan New York on May 20, 1963, a McGraw-Hill investment survey reported that business executives attributed $1.2 billion of the planned increase in plant and equipment expenditures for 1963 over actual expenditures for 1962 to the investment credit passed in 1962 by Congress and to the depreciation revisions instituted the same year by the Treasury Department. When one considers that the tax reduction given business as a result of these two changes in taxation amounted to about $2.25 billion, and this reduction in

revenues induced a 50-cent investment of each tax dollar lost, can we expect any better results from an across-the-board tax cut?

I can see no way by which this tax cut can increase the GNP by $30 to $40 billion—not without inflation—even if we accept Keynesian theory as valid and apply it to existing conditions.

The principal results of a tax cut for corporations will be increased dividends and increased foreign investment which adds to balance-of-payments difficulties. A side effect is further to entrench the Big Three's and make it more nearly impossible for new enterprises to grow up and challenge them. Competition will be increasingly a thing of the past.

Certainly a tax cut will have some effect on economic growth. But that effect, under current conditions, will be much smaller, and slower in developing, than we have been led to believe. A tax cut, especially one weighted largely in favor of those who need it least, is the most expensive and least efficient way imaginable to get an economic boost.

IV. BUDGET BALANCING

It is a bit difficult to understand how this proposed tax cut is to balance the budget.

Dr. Heller and other more or less straight Keynesians have reasoned that through the magic of the "multiplier" and "accelerator" a tax cut of about $11 billion will cause an increase in the GNP of $40 billion or so and this increased economic activity will, in turn, bring in enough taxes at the new, lower rates to balance or nearly balance the budget.

President Kennedy seemed to start out on this tack in his tax message to Congress last January. He stated, as I have already pointed out, "It would be a grave mistake to require that any tax reduction today be offset by a corresponding cut in expenditures." This is genuine Keynesian theory. A deficit-creating tax cut will spur the economy, but this stimulating action would be offset and negated by a corresponding cut in Government expenditures. If these two actions were taken at the same time, they would pretty well cancel each other out.

There was, last January, no evidence that the late beloved President Kennedy wanted to cut back on worthwhile programs. Indeed, his budgets emphasized positive programs of development and were partially responsible for our economic expansion since 1961.

Mr. Ford's group issued a pronouncement during last year's "millionaire's march on Washington" which stated:

> We, therefore, believe it possible to hold Federal expenditures in fiscal 1964 below the level set forth in the budget this January. We believe this would have been impossible without the current pressures for economics generated by a proposed tax reduction. We urge the Congress and the administration to work jointly to achieve this goal.

This rationale is interesting. We are urged to cut taxes, reduce revenues, run up larger deficits, and it is argued that this will put additional pressure on the President and the Congress to cut spending. Of course, the spending which some want to cut is in the fields devoted to the social advancement of the whole country, to the attack on poverty, ignorance, disease, and hopelessness.

If we adopt the wrong kinds of expenditure reductions, we will certainly do untold harm to the Nation and to the economy. For we must continue to pursue worthwhile programs. Highways, education, health, etc., must not suffer if the Nation is to make any worthwhile progress. But these are the programs which will suffer under the kind of philosophy embraced by Mr. Ford.

V. THE "BRAKE" THEORY

We are told that our high tax structure acts as a "brake" on the economy, stifling both investment and consumer purchasing. Releasing this "brake" will, according to the argument, promote investment and increase final demand.

A favorite propaganda trick is to state a conclusion as the basis for a second conclusion, hoping that the first conclusion will be uncritically accepted as a proven fact. Those who try to sell this "brake" theory are indulging in just such sleight of hand.

We have heard the European countries praised for their swift postwar recovery, and for their wise fiscal policies which have reportedly promoted high rates of growth. How does the tax take of these countries compare with our own?

Secretary Dillon has testified that total taxes collected by all levels of government in the United States in 1961 amounted to 28 percent of gross national product. No major European country collected a smaller percentage—France, 35 percent; Germany, 35 percent; United Kingdom, 29 percent; Italy, 28 percent.

One might legitimately discuss the incidence of certain taxes, and argue that our tax structure needs to be reformed. But this is no argument for a reduction in total revenues. It is this latter situation which we face in this bill. Will those who now advocate tax cuts for the rich soon come before the Congress to propose replacing the revenue loss by a general excise tax, further to oppress the poor?

What about this "brake" theory so far as high bracket individual taxpayers in this country are concerned?

The regrettable fact is that the rich and the very rich do not now pay their fair share of the tax burden. And this bill makes the situation more, not less, inequitable.

The very rich now pay a low percentage of their realized income in taxes. From table I below, furnished by the Treasury Department, I have developed table II which shows just how light is the taxload at the upper end of the income scale.

The "brake" theory simply does not appear plausible unless one examines the lower end of the tax and income scale. It is here that we may need to restore the broad base of purchasing power which existed prior to World War II.

TABLE I.—*Tax savings and increase in after-tax income under House bill*

[Married couple with 2 dependents, with typical dividends, capital gains and other income,[1] and typical itemized deductions]

Adjusted gross income [1]	Present law		House bill		Tax cut or increase in after-tax income		
	Tax	After-tax income [2]	Tax	After-tax income [2]	Amount	Percentage tax cut	Percentage increase in after-tax income
$3,000	0	$3,131	0	$3,131			
$4,000	$143	3,987	$103	4,027	$40	28	1
$5,000	299	4,827	219	4,907	80	27	2
$6,000	455	5,671	339	5,787	116	26	2
$7,500	719	6,971	569	7,067	150	21	2
$10,000	1,193	8,993	972	9,214	221	19	2
$12,500	1,657	11,079	1,373	11,363	284	17	3
$15,000	2,196	13,189	1,830	13,555	366	17	3
$17,500	2,745	15,288	2,296	15,737	449	16	3
$20,000	3,369	17,344	2,820	17,893	549	16	3
$25,000	4,755	21,271	3,983	22,043	772	16	4
$30,000	6,322	25,139	5,297	26,164	1,025	16	4
$40,000	10,026	32,305	8,392	33,939	1,634	16	5
$50,000	14,254	38,947	12,217	40,984	2,037	14	5
$75,000	23,799	57,421	20,672	60,548	3,127	13	5
$100,000	33,965	79,247	29,670	83,542	4,295	13	5
$200,000	63,318	184,262	56,675	190,905	6,643	11	4
$500,000	154,249	567,116	138,216	583,149	16,033	10	3
$1,000,000	261,929	1,239,659	238,037	1,263,551	23,892	9	2

[1] Includes such income as wages and salaries, interest, rents, business and partnership income, royalties, and typical dividends and capital gains. Estimates of typical dividends and realized capital gains and itemized deductions are based on 1960 tax return data.

[2] After-tax income exceeds adjusted gross income for very-high-income-tax payers because 50 percent of the long-term capital gains, which constitute a high proportion of income for such taxpayers, is included in adjusted gross income under present law and 40 percent is included under the House bill.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Oct. 11, 1963.

TABLE II.—*Effective tax rates under H.R. 8363*

[Married couple with 2 dependents, with typical dividends, capital gains, and other income,[1] and typical itemized deductions]

Adjusted gross income [1]	Realized income [2]	Tax under H.R. 8363	Tax as percentage of realized income	Adjusted gross income [1]	Realized income [2]	Tax under H.R. 8363	Tax as percentage of realized income
$3,000	$3,131	0	0	$25,000	$26,026	$3,983	15.3
$4,000	4,130	$103	2.5	$30,000	31,461	5,297	16.8
$5,000	5,126	219	4.3	$40,000	42,331	8,392	19.8
$6,000	6,126	339	5.5	$50,000	53,201	12,217	23.0
$7,500	7,636	569	7.4	$75,000	81,220	20,672	25.5
$10,000	10,186	972	9.5	$100,000	113,212	29,670	26.2
$12,500	12,736	1,373	10.8	$200,000	247,580	56,675	22.9
$15,000	15,385	1,830	11.9	$500,000	721,365	138,216	19.2
$17,500	18,033	2,296	12.7	$1,000,000	1,501,588	238,037	15.9
$20,000	20,713	2,820	13.6				

[1] Includes such income as wages and salaries, interest, rents, business and partnership income, royalties, and typical dividends and capital gains. Estimates of typical dividends and realized capital gains and itemized deductions are based on 1960 tax return data.

[2] Realized income exceeds adjusted gross income largely because adjusted gross income includes only 40 percent of capital gains under H.R. 8363 (50 percent under existing law).

NOTE.—Several items, such as tax-exempt interest, ½ of long-term capital gains, including so-called statutory gains which often have no logical relationship to capital transactions, depletion, and intangible drilling costs, are omitted from adjusted gross income and from realized income.

Source of basic data: Office of the Secretary of the Treasury, Office of Tax Analysis. See table on p. 709 of Finance Committee hearings.

The proponents of this legislation also err when they attempt to apply the "brake" theory to corporate taxation. Although stated corporate rates have not been reduced in recent years, the actual tax burden has been considerably lightened by changes in laws and regulations applicable to depreciation, and to the investment credit. Such

positive Government programs as stepped up research and development expenditures, most of which go to and through industry, have relieved corporations of the necessity for spending their own funds for activities they would otherwise have to budget for and undertake.

But let us look at corporation taxes as they are assessed against corporate gross income, not as they appear to be levied as a percentage of certain bookkeeping figures.

Just as it is necessary to go behind the stated rates and look at total income in order to know just what effective tax rate any individual pays, so is it necessary to look behind the stated 52 percent rate for corporations to determine just what the true tax and profit figures are.

Effective tax rates for corporations have been reduced quite steadily and regularly during the past few years. There were rapid amortization procedures during the Korean war, accelerated depreciation enacted in 1954, administrative changes in depreciation approved by the Treasury last year, the investment credit enacted last year, and the further liberalizing of this credit contained in the subject bill. Of course, we have retained the same stated rates, but the effect of these rates has been drastically altered, thus materially reducing the effective rate.

It seems difficult for some, economists and laymen alike, to understand that these actions have the effect of reducing the burden of income taxation on corporations. But the effect is just as real as is the effect on individuals when a new deduction, or an increase in an exemption, is enacted.

As proof of this, one has merely to look at the profits curve on page 7 of the Economic Indicators. Due to the fact that depreciation guidelines were revised so drastically last year, a new curve had to be started. The corporate profit figures are not now comparable to the figures prior to 1962.

Some facts relative to corporate profits, taxes, and cash flows are shown on table III below.

TABLE III

[In billions of dollars]

	Gross national product	Dividends paid	Corporate profits after tax	Corporate profits after tax plus capital consumption allowances	Dividends as a percent of gross national product	Dividends as a percent of corporate profits after tax	Corporate profits after tax plus CCA as a percent of gross national product	Dividends as a percent of corporate profits after tax plus CCA
1946	210.7	5.8	13.4	18.6	2.8	43.3	8.8	31.2
1947	234.3	6.5	18.2	24.5	2.8	35.7	10.5	26.5
1948	259.4	7.2	20.5	28.2	2.8	35.1	10.9	25.5
1949	258.1	7.5	16.0	24.5	2.9	46.9	9.5	30.6
1950	284.6	9.2	22.8	32.2	3.2	40.4	11.3	28.6
1951	329.0	9.0	19.7	30.7	2.7	45.7	9.3	29.3
1952	347.0	9.0	17.2	29.6	2.6	52.3	8.5	30.4
1953	365.4	9.2	18.1	32.2	2.5	50.8	8.8	28.6
1954	363.1	9.8	16.8	32.7	2.7	58.3	9.0	30.0
1955	397.5	11.2	23.0	41.4	2.8	48.7	10.4	27.0
1956	419.2	12.1	23.5	43.5	2.9	51.5	10.4	27.8
1957	442.8	12.6	22.3	44.1	2.8	56.5	10.0	28.6
1958	444.5	12.4	18.8	41.4	2.8	66.0	9.3	30.0
1959	482.7	13.7	24.5	48.7	2.8	55.9	10.1	28.1
1960	502.6	14.5	22.0	47.6	2.9	65.9	9.5	30.5
1961	518.2	15.3	21.8	48.6	3.0	70.2	9.4	31.5
1962	554.9	16.6	24.6	55.4	3.0	67.5	10.0	30.0
1963	575.7	17.4	26.1	58.0	3.0	66.7	10.1	30.0

Source: Staff of the Joint Committee on Internal Revenue Taxation.

This table shows that corporate profits after taxes just barely doubled between 1946 and 1963, while GNP almost tripled. This has led many to believe, and to state, that corporate profits have not kept pace with GNP. This has been cited as one of the reasons for our alleged slow rate of growth in recent years. It has been said that this is one reason for the lack of sufficient investment in new plant and equipment, and that this has, in turn, been one of the main causes of unemployment. Thus, the need for a tax cut for corporations.

But corporate profits after taxes plus capital consumption allowances have kept pace with GNP, running at a pretty steady 10 percent. Furthermore, dividends have kept pace with GNP, running about 3 percent.

If one claims that only the profit figures are to be considered, then he must of necessity condemn corporate management for paying out too much in dividends. Dividends being paid out today amount to about two-thirds of corporate profit after taxes. As a percentage of corporate profit after taxes, dividends have gone up 50 percent since 1946. If bookkeeping profit is in reality the key figure, then dividend payments are, without question, too high and more earnings ought to be retained.

The fact is that corporations are highly liquid, and cash flows have in recent years exceeded investment in new plant and equipment.

As for effective taxation, corporations got about $2.4 billion in tax reduction under the 1954 Internal Revenue Code. Last year they got another $2.25 billion as a result of changes in depreciation and enactment of the investment credit. What is the effective corporate tax rate? In 1946, corporate taxes amounted to about 33 percent of profits plus capital consumption allowances. Today, the comparable figure is about 29 percent. This is an effective tax reduction of about 12 percent.

Not only have we been cutting tax rates in a disguised form, but these cuts have not really been effective—or they have been inefficient—in promoting investment in plant and equipment. We have concrete proof of this.

The most optimistic statements I have seen about the effects of the $2.25 billion tax reduction given corporations last year have been to the effect that this cut has induced $1.2 billion of increased spending for plant and equipment. This is an efficiency of about 50 percent. Can we expect any better performance from this year's proposed cuts? I think not.

We give corporations a tax cut of $2 to induce them to spend $1 for plant and equipment. Hopefully this kind of expenditure, costly as it is to the Government, will create jobs. Actually it has not, and likely will not, at least not in manufacturing. We have lost about 1 million production jobs in manufacturing during the past 6 or 7 years, despite increased production.

Equity does not dictate a reduction in corporate tax rates, because dividends are maintaining pace with the economy as a whole, and the high income individuals, who own the large blocks of stock, are being given a drastic reduction in their own rates under the bill, H.R. 8363.

Economic reasons also fail to convince. A tax cut is a most inefficient way to induce expenditures by corporations. And plant and equipment expenditures in industry are not likely to create many jobs. Indeed, industry is daily accelerating the trend toward auto-

mation, thereby not only failing to create jobs, but even failing to maintain current job levels.

VI. UNEMPLOYMENT AND POVERTY

One of the more appealing arguments in favor of a mammoth tax cut is that this action will result in a drastic decrease in unemployment. It is a sad commentary on our economic and social system that so many who want and need jobs are unable to find them. Even worse, in some respects, is the fact that in many cases when jobs are available those who need those jobs are not qualified to fill them.

This is an appealing argument, because we want to insure, insofar as we are able, the right and the opportunity for each of our citizens who wants and needs a job to have one. We want our people to be self-supporting, self-reliant, prosperous, and secure.

But it is far from certain that the tax cut will reduce our excessive unemployment. Indeed, in my view, it is more likely, after about 18 months, to cause increased unemployment. A tax cut is not the place to start—or to stop a war on poverty and unemployment.

We need to look squarely at our unemployment and see just what it consists of and what has caused it. In what geographical, age, health, and ethnic areas is it concentrated? Can increased general demand cure it without causing inflation?

To begin with, we are not suffering unemployment because of a recession or depression. On the contrary, the economic indicators are, by and large, at alltime highs. We are not in that desperate condition we faced during the great depression when almost any gamble seemed in order—no matter how inefficient, or how dangerous.

We are not suffering unemployment because of lack of capital or productive capacity. The corporate sector is highly liquid; and about 12 to 15 percent of plant capacity is idle. Certainly our basic productive structure is sound, and we would have no trouble increasing production in almost any area where demand is spurred. But would this put many of the presently unemployed to work? Some confuse poverty and unemployment, and the two are closely linked. But we should always keep in mind that we do not have poverty for lack of production. Our situation economically is almost unique in recorded history. Characteristically and historically, there has been, in every society, a problem of sufficient total production. This is not our problem. We have an almost unlimited capacity to produce. Our basic problem is distribution, and the understanding of this fact is a necessary prerequisite to formulating any workable plan for an attack on unemployment and poverty. There must be a proper distribution of the fruits of national production, and this is best achieved in our society by a proper distribution of jobs which pay a decent wage.

There are two general ways of attacking unemployment. Such an attack can be directed toward increasing production and creating additional jobs. A slightly different type of attack focuses on a more equitable distribution of jobs without materially increasing total national production. We need to launch this two-pronged attack.

A tax cut does not fit into this picture. I am sorry to say that it will likely make matters worse. This is particularly true of the type of tax cut contained in the subject bill.

The first type of attack must be concentrated on increased production in the public sector, for this is where our unfulfilled demands now largely lie—for better rapid transit systems, better housing for low income groups, better educational facilities at all levels, better highways, more and better hospitals and nursing homes, more clean drinking and industrial water. It is here that jobs could readily, directly, and with profit to society, be created. But this takes public funds, which will be less available after passage of the tax bill.

Furthermore, to the extent this tax cut is effective in spurring increased investment, we are likely to build up a capacity which cannot be sustained by demand in the private sector, just as was the case in 1956–57. This may worsen unemployment in the not distant future, and especially so when accompanied by policies of economic retrenchment and monetary squeeze.

Those who would fight unemployment and poverty only by trying to increase overall demand do not understand the nature of the problem or the composition of the unemployed segment of our labor force, and the poverty-stricken in the midst of our affluence.

Present unemployment is largely structural. It is concentrated in certain geographical localities, certain age groups, certain social and ethnic categories. Unemployment is daily being worsened, or at least made more difficult to cure, by technological advances—automation, if one uses the term loosely.

From 1953 to 1962 investment in scientific research and development tripled. As a result, partially, of this effort, we are now losing 2 million jobs each year because of the laborsaving effects of increasing productivity. Manufacturing employs about 1 million fewer production workers than was the case just 6 or 7 years ago, despite vastly increased production.

This may be all to the good, and I know of no latter-day Luddites, but we must recognize the fact that no longer does increased production through increased overall demand create jobs in large numbers for the unskilled. The seeds of inflation would be sown by a shortage of skilled labor long before profitable work could be found for the bulk of presently unemployed. Altogether too large a proportion of our unemployed are not qualified to hold down productive positions in our highly mechanized and automated economy, even if those jobs could, somehow, be created.

Unemployment, and poverty, sprouting from such roots, cannot be cured by a tax cut. The type of unemployment problem we have requires more specific treatment. We must concentrate more on the public sector as well as upon encouraging and assisting private enterprise to play its part as the mainstay of our economy.

The other half of our two-pronged attack centers around encouraging certain types of persons to delay or refrain from entering the labor market—some temporarily, some permanently. After all, unemployment is a product of the participation rate—the numbers of people who say they want a job—as well as of the total number of jobs available.

One obvious place to begin here—and with profit to society—is to set up programs designed to delay the entry of young people into the labor market until they are better qualified. This would not only make for a more stable labor force, but it would also assist these young people individually to achieve a more well-rounded life, as well

as specifically to fit them for more productive jobs when they do enter the labor force. We have been altogether too timid about moving into this area. Education is the key here, not a tax cut. This kind of realistic and highly beneficial attack on unemployment will cost money, thus indicating the need for more, not less, Government revenue.

Another approach of this sort is to assist those wives and mothers who wish to devote more time to their homes and children and who really do not want to work, but who feel they must, to stay out of the active labor force. We could help them in their home life, and society as a whole, if we took steps to insure that the head of the household earned a proper wage so the family could maintain a decent standard of living without the mother having to leave the home every day to seek employment.

It is not generally realized, perhaps, just to what extent women have increasingly come into the labor force since World War II. At the same time, relatively more men have been dropping out of the labor force. This may not be socially desirable.

In 1947, the participation rate for women was 31.0 percent. This figure rose in 1962 to 36.7 percent. During the same period of time, the participation rate for men went down from 84.5 percent in 1947 to 79.3 percent in 1962.

Let me make it very, very plain that I favor full employment opportunities for men and women alike—the opportunity for a decent job for any man or woman who is able and willing to work. But I am opposed to a social and economic structure which forces wives and mothers to leave their homes and children daily to seek work because the head of the household is not paid a wage or salary which will keep the family in decent comfort. I am opposed, too, to a tax system that penalizes the parent as a taxpayer.

A tax cut for corporations and the high income brackets hardly fits in here. If a tax cut must be had, then tax relief for parents of the largest numbers of children would be fairest and of greatest benefit.

In this connection, also, we need to look more closely into the area of the minimum wage, overtime pay, and the length of the workweek.

Unemployment can be partially cured, of course, by increasing production. But, as I have pointed out, the increased production that is needed is not in the private sector where there are neither shortages nor reasonably full utilization of capacity, but in the public sector. A tax cut does not fit in here at all. Worse still, the capacity of the Government to provide for our pressing public needs will be seriously and permanently impaired by a drastic reduction in revenue.

We cannot cure unemployment and poverty by reducing revenues and leaving ourselves defenseless, bereft of our most useful weapon, before the onslaught of the next recession.

VII. BALANCE-OF-PAYMENTS CONSIDERATIONS

Because the economic royalists who are now running the Treasury Department refuse to take positive action to stem the outflow of private capital, or to take such other steps as might be indicated, the balance-of-payments problem persists. Indeed, our situation can hardly be said to have improved at all.

During 1962 there was some apparent improvement—more apparent than real, because there were several special operations, such as advance repayments well ahead of schedule, on obligations of certain foreign governments.

During the first half of 1963, capital flows reached runaway proportions. The apparent improvement during the last half of the year may be illusory, representing only a partially balancing of forces at work earlier in the year.

It is felt by proponents of the subject bill that a tax cut will help materially in solving our balance-of-payments problem. It will not.

It is felt, first, that the cost of production will be lower and our goods will be more competitive in world markets. We have not achieved lower prices as a result of the investment credit and depreciation changes, and both had the effect of reducing corporate taxes. We will not achieve lower prices as a result of this tax cut.

Even if we were to achieve lower prices through any mechanism whatsoever, this would not materially increase exports. Other countries use direct controls to regulate imports of merchandise and exports of capital. Witness the "chicken war." We will certainly not achieve a sufficiently large favorable balance in goods and services to overcome other areas of deficiency.

Proponents of this bill also claim that the economy will be so booming—without inflation, of course—and domestic investment will pay off so handsomely as a result of the enactment of this bill that no longer will money go abroad to find a higher rate of return.

This is an argument which is so fantastic that it is difficult to answer.

Investment decisions are dictated by many considerations—markets, raw materials, costs, taxes—and so long as out investors can earn high rates of return abroad, and build up their investment without the necessity of paying U.S. taxes, there will be continued encouragement to send funds abroad.

In 1962, the Congress took a timid step in the direction of closing off some of the tax haven operations abroad, but this did not really reach the direct investment problem.

In 1963, after it became apparent that interest rates could not be pushed high enough to stop portfoilo outflows without doing untold damage to the domestic economy, the administration proposed the so-called interest equalization bill. The threat of this legislation appears to have had some effect on portfolio outflows, but this effect now appears to be wearing thin.

It seems to be obvious that a positive program of regulation of capital flows is the answer to our direct and portfolio outflow of capital. But it would appear that no action along this line will be taken. Barring such action, the approach of indirect regulation by taxation is the next best thing. It is not sufficiently selective. Methods of avoidance will be found. But if this is the best we can do, let us at least do that.

All other modern industrial countries invoke positive controls whenever it appears to be in their interest to do so. The fact that we do not is difficult to understand or justify.

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The most likely effects of the bill on the balance of payments are—

1. Increased imports.
2. No material change in exports. The domestic price level is, to the extent the bill is at all effective, likely to be inflated. This will likely make exports move more slowly.
3. Higher interest rates. This may slow down portfolio outflows, but it will, in turn, slow down the whole domestic economy.

All in all, it would seem that the bill will not help achieve a balance in our international payments.

VIII. TAX REDUCTION AND INFLATION

If I understand correctly the position of the proponents of this bill, it is not that it will help to curb inflation; rather, it will boost economic activity without causing inflation.

It is claimed that, because we now have high unemployment and unused plant capacity, we can have greatly increased production without inflationary pressures.

Although inflation does not seem to be a matter of major concern at the moment, the Consumer Price Index has crept up consistently, and some commodities are now beginning to push upward in price.

But what will happen if the tax cut really does react in the way its proponents hope it will?

Can any really large dent be made in the ranks of the unemployed without putting pressure on certain skills and categories of workers?

There are some relatively scarce categories of trained personnel, and pressures will be felt in these categories even though we still have several million of the unskilled and uneducated unemployed.

But what really concerns me more is the tight rope which must be walked—it is felt—by our money managers. My fear is that, in attempting to guard against monetary inflation, the Federal Reserve Board will raise interest rates and restrict the supply of money so that, having rid our house of the supposed evil spirit of high taxes, we will find it filled with the even more malevolent spirits of high interest rates, tight money, restrictive debt management, and reduced spending. Truly our final state will be worse than our former.

IX. EQUITY

Although economic considerations are important when considering the tax structure, equity must not be ignored.

There is little equity in this bill.

The new minimum standard deduction gives some relief to the lowest income groups, but it is not enough.

There is no better way to show the basic inequity of the changes in the rate structure which this bill makes—by far the most important part of the bill—than to note the increase in after-tax income or take-home pay which this bill gives to various income groups.

The tables below were prepared by the staff of the Joint Committee on Internal Revenue Taxation, and show (col. 8) the treatment which taxpayers in various income groups will receive from the rate reductions.

TABLE IV.—*Individual income tax liability: Under present-law tax rates, under H.R. 8363 tax rates, and under uniform percentage increase in taxable income after present-law tax; selected levels of taxable income, 1965, single person*

Taxable income	Tax		Taxable income after tax		Reduction in tax or increase in taxable income after tax				
					Under H.R. 8363			Under uniform percentage increase in taxable income after tax (5.95 percent)	
	Present law	H.R. 8363	Present law	H.R. 8363	Amount	As percent of present-law tax	As percent of taxable income after present-law tax	Amount	As percent of present-law tax
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$500	$100	$70	$400	$430	$30	30.0	7.5	$24	24.0
$1,000	200	145	800	855	55	27.5	6.9	48	24.0
$1,500	300	225	1,200	1,275	75	25.0	6.3	71	23.7
$2,000	400	310	1,600	1,690	90	22.5	5.6	95	23.8
$4,000	840	690	3,160	3,310	150	17.9	4.7	188	22.4
$6,000	1,360	1,130	4,640	4,870	230	16.9	5.0	276	20.3
$8,000	1,960	1,630	6,040	6,370	330	16.8	5.5	359	18.3
$10,000	2,640	2,190	7,360	7,810	450	17.0	6.1	438	16.6
$12,000	3,400	2,830	8,600	9,170	570	16.8	6.6	512	15.1
$14,000	4,260	3,550	9,740	10,450	710	16.7	7.3	580	13.6
$16,000	5,200	4,330	10,800	11,670	870	16.7	8.1	643	12.4
$18,000	6,200	5,170	11,800	12,830	1,030	16.6	8.7	702	11.3
$20,000	7,260	6,070	12,740	13,930	1,190	16.4	9.3	758	10.4
$22,000	8,380	7,030	13,620	14,970	1,350	16.1	9.9	810	9.7
$26,000	10,740	9,030	15,260	16,970	1,710	15.9	11.2	908	8.5
$32,000	14,460	12,210	17,540	19,790	2,250	15.6	12.8	1,044	7.2
$38,000	18,360	15,510	19,640	22,490	2,850	15.5	14.5	1,169	6.4
$44,000	22,500	18,990	21,500	25,010	3,510	15.6	16.3	1,279	5.7
$50,000	26,820	22,590	23,180	27,410	4,230	15.8	18.2	1,379	5.1
$60,000	34,320	28,790	25,680	31,210	5,530	16.1	21.5	1,528	4.5
$70,000	42,120	35,190	27,880	34,810	6,930	16.5	24.9	1,650	3.9
$80,000	50,220	41,790	29,780	38,210	8,430	16.8	28.3	1,772	3.5
$90,000	58,620	48,590	31,380	41,410	10,030	17.1	32.0	1,867	3.2
$100,000	67,320	55,490	32,680	44,510	11,830	17.6	36.2	1,944	2.9
$150,000	111,820	90,490	38,180	59,510	21,330	19.1	55.9	2,272	2.0
$200,000	156,820	125,490	43,180	74,510	31,330	20.0	72.6	2,569	1.6
$300,000	247,820	195,490	52,180	104,510	52,330	21.1	100.3	3,105	1.3
$400,000	338,820	265,490	61,180	134,510	73,330	21.6	119.9	3,640	1.1
$600,000	520,820	405,490	79,180	194,510	115,330	22.1	145.7	4,711	.9
$800,000	696,000	545,490	104,000	254,510	150,510	21.6	144.7	6,188	.9
$1,000,000	870,000	685,490	130,000	314,510	184,510	21.2	141.9	7,735	.9

Source: Staff of the Joint Committee on Internal Revenue Taxation, Oct. 4, 1963.

TABLE V.—*Individual income tax liability under present law tax rates, under H.R. 8363 tax rates, and under uniform percentage increase in taxable income after present law tax; selected levels of taxable income; 1965; married couple—joint return*

Taxable income	Tax		Taxable income after tax		Reduction in tax or increase in taxable income after tax				
					Under H.R. 8363			Under uniform percentage increase in taxable income after tax (5.95 percent)	
	Present law	H.R. 8363	Present law	H.R. 8363	Amount	As percent of present law tax	As percent of taxable income after present law tax	Amount	As percent of present law tax
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$1,000	$200	$140	$800	$860	$60	30.0	7.5	$48	24.0
$2,000	400	290	1,600	1,710	110	27.5	6.9	95	23.8
$3,000	600	450	2,400	2,550	150	25.0	6.3	143	23.8
$4,000	800	620	3,200	3,380	180	22.5	5.6	190	23.8
$8,000	1,680	1,380	6,320	6,620	300	17.9	4.7	376	22.4
$12,000	2,720	2,260	9,280	9,740	460	16.9	5.0	552	20.3
$16,000	3,920	3,260	12,080	12,740	660	16.8	5.5	719	18.3
$20,000	5,280	4,380	14,720	15,620	900	17.0	6.1	876	16.6
$24,000	6,800	5,660	17,200	18,340	1,140	16.8	6.6	1,023	15.0
$28,000	8,520	7,100	19,480	20,900	1,420	16.7	7.3	1,159	13.6
$32,000	10,400	8,660	21,600	23,340	1,740	16.7	8.1	1,285	12.4
$36,000	12,400	10,340	23,600	25,660	2,060	16.6	8.7	1,404	11.3
$40,000	14,520	12,140	25,480	27,860	2,380	16.4	9.3	1,516	10.4
$44,000	16,760	14,060	27,240	29,940	2,700	16.1	9.9	1,621	9.7
$52,000	21,480	18,060	30,520	33,940	3,420	15.9	11.2	1,816	8.5
$64,000	28,920	24,420	35,080	39,580	4,500	15.6	12.8	2,087	7.2
$76,000	36,720	31,020	39,280	44,980	5,700	15.5	14.5	2,337	6.4
$88,000	45,000	37,980	43,000	50,020	7,020	15.6	16.3	2,559	5.7
$100,000	53,640	45,180	46,360	54,820	8,460	15.8	18.2	2,758	5.1
$120,000	68,640	57,580	51,360	62,420	11,600	16.1	21.5	3,056	4.5
$140,000	84,240	70,380	55,760	69,620	13,860	16.5	24.9	3,318	3.9
$160,000	100,440	83,580	59,560	76,420	16,860	16.8	28.3	3,544	3.5
$180,000	117,240	97,180	62,760	82,820	20,060	17.1	32.0	3,734	3.2
$200,000	134,640	110,980	65,360	89,020	23,660	17.6	36.2	3,889	2.9
$300,000	223,640	180,980	76,360	119,020	42,660	19.1	55.9	4,543	2.0
$400,000	313,640	250,980	86,360	149,020	62,660	20.0	72.6	5,138	1.6
$600,000	495,640	390,980	104,360	209,020	104,660	21.1	100.3	6,209	1.3
$800,000	677,640	530,980	122,360	269,020	146,660	21.6	119.9	7,280	1.1
$1,000,000	859,640	670,980	140,360	329,020	188,660	21.9	134.4	8,351	1.0

Source: Staff of the Joint Committee on Internal Revenue Taxation, Oct. 4, 1963.

These tables show some very disturbing results. Whereas a married couple filing a joint return, having a taxable income subject to ordinary income rates of $3,000 per year, will gain $150 from the rate reductions in the bill, the more affluent couple with a taxable income of $300,000 will pick up an extra $42,660. As a percentage of taxable income, this would mean an extra 6.3 percent to this $3,000 couple, but an extra 55.9 percent to the $300,000 couple. For the really rich, the gain would be more than 100 percent in take-home pay after tax income.

It has been pointed out, and I want this clearly understood, that the table does not reflect the full picture insofar as the rich and very rich are concerned. The typical high income taxpayer is able to take advantage of many loopholes in the law. The affluent do not pay taxes in accordance with the regular, ordinary income tax rates. But the table does show the true picture with respect to whatever taxable income any taxpayer has to which the published ordinary income rates apply.

The majority of Americans pay their taxes in accordance with the stated rates. This is not true, however, of the "typical" taxpayer with a very large income. But the gain which would be realized under the tax bill by those in the upper income groups would be tremendous. In my view, it would be grossly unfair.

A far more equitable way of reducing taxes, if we can afford a large reduction in governmental revenue, would be to raise the personal exemption for each taxpayer and each dependent. This would give everyone a more nearly equal and equitable amount of tax benefit.

Referring again to the table, it shows that a taxpayer with a small income would receive a very small percentage increase in take-home pay. It would be a percentage increase of a small amount. But those who have large taxable incomes would receive a large percentage increase in take-home pay. It would be a large percentage of a large amount.

Instead of the pending bill making our tax system more progressive, more equitable, more stimulative primarily of the consumer element of our economy, it would do just the reverse. Its enactment would bring a more regressive tax law, a more unfair tax law, a more unjust tax law, and would allow those with really large incomes, who now do not pay their fair share now to pay less.

X. SUMMARY OF RATE REDUCTION ASPECTS OF THE BILL

With 3 years of rapidly expanding economy behind us and the prospect of another good year—perhaps the best in our history—before us, it would appear that our economy is doing quite well.

From the viewpoint of those who would use fiscal policy actively in a countercyclical way, this would appear to be the worst possible time to initiate and carry through a tax cut.

If a tax cut is indicated, the nature and magnitude of the cut could hardly coincide with the one provided by this bill. The broad base of our consumer purchasing power has not been restored since World War II, and it is this element of our economy, in the private sector, which may possibly need some stimulation. This kind of stimulation can best be brought about by raising the personal exemption. Equity, likewise, would dictate such a change.

We do have high unemployment and pockets of poverty, but the indicated corrective action must take into account specific problems and any acceptable solution must provide specific solutions. Increasing overall demand artificially through a tax cut which is poorly balanced will do little and at great cost.

Positive programs of education, and increased production in the public sector, will accomplish much, and at less cost in money. Moreover the benefits to society would be immeasurable in the long run.

STRUCTURAL CHANGES

I. GENERAL

This bill makes a mockery of tax reform. There has been a tremendous slippage in reform from the general tenor of the remarks of administration spokesmen in 1962, to the actual proposals advanced by President Kennedy in January 1963, to the bill as approved by the Ways and Means Committee, and finally to the bill now reported from the Finance Committee.

I think it is not too extreme to say that this bill, providing as it does for enormous tax benefits for the rich and very rich through rate reduction in the upper bracket has rung the death knell for tax reform. What little reform there is in the bill, and it is miniscule when measured by obvious needs, will mark the last serious effort at reform for a generation.

Given a decent amount of time, the Senate might possibly be prevailed upon to make some significant moves toward reform. But the drumfire of propaganda and pressure for passage of this bill without quite taking the time to read it has made any serious discussion difficult if not impossible.

Under the circumstances, it is necessary to concentrate on a very few structural changes. My efforts shall be directed toward defending the public interest against special interest raids. There is so little hope of positive reform. There is such great fear of further damage.

II. THE INVESTMENT CREDIT

As is so often the case, a tax loophole once opened is quickly widened. The crevice deepens and an apparently slight erosion of the tax base soon becomes a great gully. Often this is a process which takes a few years. In the case of the investment credit, however, the ink was hardly dry when the beneficiaries of this tax refund—a refund which must come out of the pockets of average taxpayers—began efforts to fatten themselves further.

I will not here repeat what was stated in minority views signed by Senator Paul Douglas and me when the investment credit was first adopted in 1962. For anyone who might be interested, I would cite the Report of the Committee on Finance on the Revenue Act of 1962, page 396.

Section 203 of the subject bill as reported by the Finance Committee simply makes the investment credit twice as bad as it was when it was enacted. The credit now becomes an outright gift, with not even the pretense of partial recovery through slightly decreased depreciation allowances.

There is one additional provision in this section, however, which does not even relate to revenues, and therefore has no place in this bill, but which is conducive of untold mischief. I refer to section 203(e), which would direct the Federal regulatory agencies not to order any of the benefits of the investment credit "flowed through" to consumers.

Regulatory agencies have two basic choices in handling the treatment of the tax refunds represented by the investment credit.

One method is to "flow through" the tax cut, that is, put the tax savings into the net profit figure, where it would, of course, operate to raise the utility's rate of return. It does so operate, even if the company and the regulatory agency agree to allow it to be hidden somewhere else in the books—or to pretend it does not exist, that all apparent taxes were actually paid. But if logic, equity, and decency prevail, this tax savings will be shown as a reduction of costs, or an increase in profits, and the consumer, the customer of the utility, will eventually benefit through reduced rates.

The other choice, and the one which would in effect be ordered by this bill, is to "normalize" the tax savings, that is, to permit the utility to use this tax refund as it sees fit, while continuing to charge its customers the full price it would be allowed to charge if these taxes were, in fact, actually paid.

I think it is not putting the matter too strongly to say that the Congress is, with the passage of this bill with this section intact, ordering the regulatory agencies to participate in the perpetration of a fraud on the consumers of electricity, gas, and other goods and services which come to them from these favored companies which have been given monopolies, and against whom the consumer has no recourse—there is no competitive choice available to him.

On January 23, 1964, the Federal Power Commission announced its decision in favor of "flow through." Other Federal regulatory agencies are reluctant and indecisive, and are dawdling in the hope the Congress will prohibit them from performing their duty. They have been standing by since the investment credit was enacted in 1962.

But even industry spokesmen have, in some instances, spoken out against this unconscionable theft from their customers.

Mr. Donald C. Cook, president of American Electric Power Co., Inc., in a letter to the chairman of the Finance Committee, a copy of which was very kindly sent to me, and I am sure to all members of the committee, by Mr. Cook, has set out his views on this subject.

Here is a paragraph from Mr. Cook's letter:

> It is my view that the investment credit does in fact represent a reduction in current Federal income tax expense, and therefore a reduction in current operating expenses; that the investment credit will stimulate capital expenditures by utilities even if all or part of the tax saving is passed on to customers, or if the tax saving forestalls or reduces an otherwise necessary increase in rates; and, indeed, that the use of this tax saving to reduce or avoid an increase in the price of the taxpayer's product is best calculated to increase demand and in turn to stimulate plant investment, and thus to carry out the basic objectives underlying the adoption of the credit.

Mr. Cook went on to say that he understood that his views were shared by many other utility companies and regulatory agencies.

The question of equity and forced, if not false, bookkeeping aside, there are tremendous sums of money involved. By the passage of this section, the Congress is taking away from consumers some $300 million per year by forcing higher rates on the customers of natural gas pipelines and electric utilities under the jurisdiction of the Federal Power Commission alone, considering both their interstate and intrastate business. And this is just one segment of regulated activities.

If the matter would stop with the handling of the investment credit, the situation would be bad enough. But already proposals have been advanced to have the Congress order the Federal regulatory agencies to allow regulated monopolies to "normalize" with respect to other funds.

During the Korean war, rapid amortization certificates were issued to many companies. In the 1954 Code, accelerated depreciation was approved. As a consequence, the sums of money collected from consumers by the monopolies operating in the utility field—supposedly regulated—are truly astronomical.

Amendment No. 350 to this bill has already been offered and may well be brought up during floor debate. This amendment would order the Federal regulatory agencies to give the same treatment this bill accords the investment credit to amounts set aside under liberalized depreciation provisions.

Accumulated deferred taxes of companies under the jurisdistion of the Federal Power Commission amounted to some $2 billion at the end of 1962.

These amounts, set aside under provisions of section 167 and 168 of the code, have given rise to sizable tax-free dividends. With the enactment of the principle enunciated in this bill, section 203(e), consumers will be denied the benefit of past rate reductions. They will continue to pay rates based on phantom, nonexistent taxes which show on the books, but which are never, in actuality, paid.

III. CAPITAL GAINS TREATMENT

In one major respect, the Finance Committee has improved the bill. The committee decided to delete the provision in the House-passed version of this measure which provided for an inclusion factor of only 40 percent (50 percent under present law) and a maximum rate of 21 percent (25 percent under present law) for capital gains on assets held for 2 years or longer.

It is in the capital gains area that muchof the tax dodging takes place, and this action on the part of the committee is highly commendable. At least, it is commendable in that the committee did not make a sorry situation sadder. The committee did not, of course, go so far as to make any real improvement in existing law. Holding the line, however, is a noteworthy accomplishment.

It has become customary to reduce effective tax rates by allowing many transactions which are not logically capital transactions to be so classified. One often hears of a highly compensated executive "running his money through" oil or timber or cattle. Hopefully the time will come when some real progress can be made toward correcting the many abuses associated with capital gains. In the

meantime, it is important that things not be made even more unwholesome by reducing capital gains rates.

It is through the capital gains route that the rich and very rich are often able to reduce their effective tax rates. In this connection, the table prepared by the Treasury and which appears on page 2606 of the Finance Committee hearings, is most revealing.

This table shows that, under existing law, a taxpayer with adjusted gross income of $700,000 may pay an effective tax rate which will vary from 20.1 percent to 47.6 percent, according to whether he has a high or low proportion of capital gains in his income. Under the House bill, of course, the situation is worse, his rates varying from 18.1 to 39.9 percent.

What ever happened to the 91 percent, so-called "confiscatory" tax rate?

This table also shows that the taxpayer with adjusted gross income of $2 million might pay a rate as high as 46 percent if he has little capital gains, or as low as 18.5 percent if he has a lot of capital gains, under terms of the bill.

Incidentally, although the Treasury elsewhere has tried to show that the rich and very rich gain little from the bill's rate reductions for ordinary income, this table shows that this $2 million man with little capital gains keeps a full 10 percentage points more after taxes under the bill, and would have his effective rate cut from 56.7 percent under existing law to 46 percent under the House bill. This is a pretty good measure of the benefits he receives from the rate reduction part of this bill—upward of $200,000.

IV. STOCK OPTIONS

So much has been said by me and others on the evils of the restricted stock option that it would serve no useful purpose to repeat it here. I would call attention, for those who might be interested, to remarks which I made on the Senate floor during 1961, specifically on April 14, April 24, April 27, May 4, June 8, and August 8. The hearings held by the Finance Committee on this subject on July 20 and 21, 1961, also contain useful information, as do the hearings on the subject bill.

There are some basic objections to the restricted stock option.

First, it is a device which enables corporate insiders to take money from the corporation which rightfully belongs to the stockholders.

Second, it is another of the many gimmicks associated with capital gains by which ordinary income, in this case compensation, is treated as a capital gain for income tax purposes.

Third, it encourages manipulation on the part of corporate insiders which will work harm, in varying degrees, to the whole economy, and specifically to the securities markets.

The recently publicized Chrysler Corp. incident involving options is a good case in point, and I commend to my colleagues as interesting reading the report prepared by the Treasury for the Finance Committee on this maneuver.

The subject bill makes some improvement in the option area. It will, if enacted into law, cure some abuses. It will not cure all abuses, however, and I shall renew my efforts to remove from the bill the new "qualified" stock option which replaces the old section 421 type of "restricted" stock option.

ALBERT GORE.

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Calendar No. 805

88TH CONGRESS } SENATE { REPORT No. 830
2d Session } { Part 2

REVENUE ACT OF 1964

SUPPLEMENTAL REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

TO ACCOMPANY

H.R. 8363

A Bill To Amend the Internal Revenue Code of 1954 To Reduce Individual and Corporate Income Taxes, To Make Certain Structural Changes With Respect to the Income Tax, and for Other Purposes

JANUARY 31, 1964.—Ordered to be printed

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Calendar No. 805

88TH CONGRESS 2d Session } SENATE { REPT. 830 Part 2

REVENUE ACT OF 1964

JANUARY 31, 1964.—Ordered to be printed

Mr. LONG of Louisiana, from the Committee on Finance, submitted the following

SUPPLEMENTAL REPORT

[To accompany H.R. 8363]

TECHNICAL EXPLANATION OF THE BILL

SECTION 1. SHORT TITLE, ETC.

(a) *Short title.*—Subsection (a) of section 1 of the bill (sec. 2 of the bill as passed by the House) provides that the bill may be cited as the "Revenue Act of 1964."

(b) *Amendment of 1954 Code.*—Subsection (b) of section 1 of the bill provides that whenever in the bill an amendment or repeal is expressed in terms of an amendment to or repeal of a section or other provision, the reference is considered to be made to a section or other provision of the Internal Revenue Code of 1954.

TITLE I—REDUCTION OF INCOME TAX RATES AND RELATED AMENDMENTS

PART I—INDIVIDUALS

SECTION 111. REDUCTION OF TAX ON INDIVIDUALS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page A–9 of the report of the Committee on Ways and Means on the bill (H. Rept. 749, 88th Cong., 1st sess.).

SECTION 112. MINIMUM STANDARD DEDUCTION

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-10 of the report of the Committee on Ways and Means on the bill.

SECTION 113. RELATED AMENDMENTS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-12 of the report of the Committee on Ways and Means on the bill.

SECTION 114. CROSS REFERENCES TO TAX TABLES, ETC.

Section 114 of the bill contains cross references to the provisions of the bill relating to optional tax if adjusted gross income is less than $5,000 (sec. 301) and income tax collected at source (sec. 302).

PART II—CORPORATIONS

SECTION 121. REDUCTION OF TAX ON CORPORATIONS

Your committee has approved this section except for a technical clarifying change discussed below.

Section 121 of the bill amends section 11 of the code (relating to tax on corporations). Under the bill as passed by the House, subsection (d) of section 11 of the code provided that for purposes of subtitle A of the code (relating to income tax) the surtax exemption for any taxable year was to be $25,000 or the amount determined under section 1561 of the code (relating to surtax exemptions in case of certain controlled corporations), as added by section 237 of the bill (section 223 of the bill as passed by the House). Your committee has made a clarifying amendment, and as amended subsection (d) of section 11 provides that for purposes of subtitle A the surtax exemption for any taxable year is $25,000, except that, with respect to a corporation to which section 1561 applies, the surtax exemption is the amount determined under such section.

For the technical explanation of this section of the bill, see page A-12 of the report of the Committee on Ways and Means on the bill.

SECTION 122. CURRENT TAX PAYMENTS BY CORPORATIONS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-13 of the report of the Committee on Ways and Means on the bill.

SECTION 123. RELATED AMENDMENTS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-16 of the report of the Committee on Ways and Means on the bill.

PART III—EFFECTIVE DATES

SECTION 131. GENERAL RULE

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-17 of the report of the Committee on Ways and Means on the bill.

SECTION 132. FISCAL YEAR TAXPAYERS

Except for conforming changes referring to the "Revenue Act of 1964" (instead of the "Revenue Act of 1963"), this section has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-17 of the report of the Committee on Ways and Means on the bill.

TITLE II—STRUCTURAL CHANGES

SECTION 201. DIVIDENDS RECEIVED BY INDIVIDUALS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-20 of the report of the Committee on Ways and Means on the bill.

SECTION 202. LIMITATION ON RETIREMENT INCOME

Section 202 of the bill, which is a new section added to the bill as passed by the House, amends section 37 of the code by inserting a new subsection (i) therein. Section 37 relates to the retirement income credit.

Under existing law eligible taxpayers 65 or over who receive taxable pensions or annuities, interest, rents, dividends, etc., and eligible taxpayers, regardless of age, who receive taxable pensions or annuities under public retirement systems (as defined in section 37(f)), are allowed a retirement income credit. To be eligible for the retirement income credit, a taxpayer must have received in each of any 10 calendar years before the taxable year earned income (as defined in section 37(g)) in excess of $600. The amendments made by section 202 of the bill make no change in existing law with respect to the foregoing.

Under existing law, the retirement income credit is computed by multiplying the amount of retirement income, limited to a maximum of $1,524, by the rate of tax on the first $2,000 of taxable income. The amendments made by your committee increase the limitation on retirement income under certain circumstances and are discussed below. Also under subsection (a) of section 113 of the bill, the rate against which retirement income (as defined in subsection (c) and as limited by subsection (d) of section 37) is to be multiplied for purposes of computing the retirement income credit is established as 15 percent.

Under existing law, the maximum retirement income of an individual on which the credit may be based ($1,524) is reduced by amounts received as a pension or annuity either under title II of the Social Security Act or under the Railroad Retirement Act of 1935 or 1937, and by amounts received from other pensions or annuities which

are exempt from tax. In the case of an individual who has attained the age of 62 but who has not attained the age of 72 before the close of the taxable year, the maximum retirement income on which credit may be based is also reduced by the sum of one-half the amount of earned income received during the taxable year in excess of $1,200 but not in excess of $1,700 and the amount of earned income in excess of $1,700. In the case of an individual who has not attained the age of 62 before the close of the taxable year, the maximum retirement income is reduced by the amount of earned income received during the taxable year in excess of $900.

Under existing law, the retirement income credit is computed separately for each spouse and each spouse is required to meet the earned income test in section 37(b) ($600 of earned income in each of any 10 prior years); except that in the case of a widow or widower whose spouse had received such earned income, such widow or widower is considered to have received earned income.

Subsection (a) of section 202 of the bill adds a new subsection (i) to section 37 of the code. The new subsection (i) provides for an increase, in certain cases, in the limitation on retirement income in the case of married taxpayers both of whom have attained the age of 65 before the close of the taxable year and who file a joint return for the taxable year.

Paragraph (1) of new section 37(i) provides that if both spouses meet the earned income test in subsection (b) of section 37 and if the sum of the retirement income and the amounts described in paragraphs (1) and (2) of subsection (d) of such section received by either spouse during the taxable year is less than $762, the $1,524 amount referred to in subsection (d) shall, with respect to the other spouse, be increased by an amount equal to the amount by which such sum is less than $762. If such sum is equal to or greater than $762, no such adjustment shall be made. The application of the provisions of paragraph (1) of new section 37(i) may be illustrated by the following example:

Example 1.—H and W, each of whom are 66 years of age and each of whom meets the earned income test in section 37(b), file a joint return for the calendar year 1964. During 1964, H receives as his only income $8,000 of retirement income and no social security benefits or other amounts described in paragraph (1) of section 37(d). During 1964, W receives as her only income $100 of retirement income and $500 under title II of the Social Security Act.

Under existing law, H is entitled to a retirement income credit computed on the maximum retirement income of $1,524. W is entitled to a retirement income credit computed on $100 of retirement income.

Under the new section (i), the $1,524 limitation on the retirement income of H would be increased by $162. The $162 increase is computed under paragraph (1) of new subsection (i) by subtracting from $762 the sum of the retirement income received by W ($100) and the social security benefits received by W ($500). The retirement income credit of W is not affected.

Paragraph (2) of new section 37(i) provides that if either spouse does not meet the earned income test in subsection (b) of section 37, the $1,524 amount referred to in subsection (d) of such section shall, with respect to the other spouse, be increased by $762 minus the sum of the amounts described in paragraphs (1) and (2) of subsection (d) received by the spouse who did not meet the earned income test.

The application of the provisions of paragraph (2) of new section (i) may be illustrated by the following example:

Example 2.—Assume the same facts as in example 1 above except that W does not meet the earned income test in section 37(b). Under existing law, H is entitled to a retirement income credit computed on the maximum retirement income of $1,524. (W is not entitled to any retirement income credit.)

Under the new section 37(i), the $1,524 limitation on the retirement income of H would be increased by $262. The $262 increase is computed under paragraph (2) of new subsection (i) by subtracting from $762 the social security benefits received by W ($500).

Subsection (b) of section 202 of the bill provides that the amendments made by section 202 of the bill apply to taxable years beginning after December 31, 1963.

SECTION 203. REPEAL OF REQUIREMENT THAT BASIS OF SECTION 38 PROPERTY BE REDUCED BY 7 PERCENT; OTHER PROVISIONS RELATING TO INVESTMENT CREDIT

Your committee has approved subsection (a) of section 203 of the bill (section 202(a) of the bill as passed by the House) with changes in the effective dates (discussed below); and has approved subsections (b) through (f) without change. For the technical explanation of subsections (b) through (f) of section 203 (sec. 202 of the bill as passed by the House) of the bill, see page A-25 of the report of the Committee on Ways and Means on the bill.

(*a*) *Repeal of requirement that basis be reduced.*—Subsection (a) of section 203 of the bill repeals section 48(g) of the code, which relates to adjustments to basis of section 38 property (that is, property with respect to which an investment credit is allowable), with respect to such property placed in service after December 31, 1963. In the case of property placed in service before January 1, 1964, subsection (a) of section 203 of the bill repeals section 48(g) with respect to taxable years beginning after December 31, 1963, and provides for an increase in basis as of the first day of the taxpayer's first taxable year which begins after December 31, 1963. Subsection (a) of section 203 also makes certain related amendments to the code.

Repeal of reduction in basis under section 48(g)(1)

Paragraph (1) of section 203(a) of the bill repeals paragraph (1) of section 48(g) of the code. (See below for discussion of repeal of paragraph (2) of sec. 48(g).) Under paragraph (1) of section 48(g), the basis of any section 38 property is reduced by an amount equal to 7 percent of the qualified investment (as determined under sec. 46(c)) with respect to such property. This reduction in basis is taken into account for purposes of subtitle A of the code, relating to income tax, except for purposes of computing, or recomputing, the investment credit. Thus, the reduction in basis is taken into account for purposes of computing depreciation deductions and for purposes of computing gain or loss on the sale or other disposition of the property.

This repeal is effective (under par. (4) of sec. 203(a) of the bill), in the case of section 38 property placed in service after December 31,

1963, with respect to taxable years ending after December 31, 1963; and in the case of property placed in service before January 1, 1964, with respect to taxable years beginning after December 31, 1963. Thus, a taxpayer who makes his return on the basis of a fiscal year ending March 31, must reduce the basis of any section 38 property placed in service before January 1, 1964, but is not required to reduce the basis of any section 38 property placed in service after December 31, 1963. No reduction in basis is to be made in the case of section 38 property the construction, reconstruction, or erection of which is completed, or which is acquired, before January 1, 1964, but which is placed in service after December 31, 1963.

Repeal of increase in basis under section 48(g)(2)

Paragraph (1) of section 203(a) of the bill also repeals paragraph (2) of section 48(g) of the code. Under paragraph (2) of section 48(g), if the tax under chapter 1 of the code is increased for any taxable year under paragraph (1) or (2) of section 47(a) of the code (relating to certain dispositions, etc., of sec. 38 property) or an adjustment in carrybacks or carryovers is made under paragraph (3) of such section, the basis of the property described in such paragraph (1) or (2) of section 47(a) is increased by an amount equal to the portion of such increase in tax, or the portion of such adjustment to carrybacks or carryovers, attributable to such property. The increase in basis is made immediately before the event which causes paragraph (1) or (2) of section 47(a) to apply. Thus, the increase in basis is taken into account for purposes of determining gain or loss on a disposition of the property.

This repeal is effective (under par. (4) of sec. 203(a) of the bill), in the case of section 38 property placed in service after December 31, 1963, with respect to taxable years ending after December 31, 1963; and in the case of property placed in service before January 1, 1964, with respect to taxable years beginning after December 31, 1963. Thus if, in February 1964, section 47(a) (1) or (2) applies to increase the tax of a taxpayer who makes his return on the basis of a fiscal year ending March 31, under chapter 1 of the code with respect to property placed in service in 1962, the basis of such property is increased under section 48(g)(2) by the amount of such increase in tax.

Increase in basis of property on account of prior reduction

Paragraph (2)(A) of section 203(a) of the bill provides, in general, that the basis of any section 38 property (as defined in sec. 48(a) of the code) placed in service before January 1, 1964, is to be increased, under regulations prescribed by the Secretary of the Treasury or his delegate, by an amount equal to 7 percent of the qualified investment with respect to such property. In determining the amount of such increase in basis, any prior increase in basis with respect to the property under section 48(g)(2) (in taxable years beginning before Jan. 1, 1964) is to be taken into account. Thus, the amount of the increase in basis under paragraph (2)(A) of section 203(a) of the bill is equal to the amount of the reduction in basis under section 48(g)(1) less any increase in basis under section 48(g)(2) with respect to such property. The basis of any section 38 property is not increased under paragraph (2)(A) of section 203(a) of the bill if the taxpayer dies in a taxable year beginning before January 1, 1964.

The increase in basis provided by paragraph (2)(A) of section 203(a) of the bill is to be made, under paragraph (2)(C) of section 203(a), as of the first day of the first taxable year of the taxpayer which begins after December 31, 1963. Generally, such increase in basis is to be taken into account by the person whose basis of the property was reduced under section 48(g)(1). Thus, in the case of partnership section 38 property, the increase in basis is to be taken into account by the partnership as of the first day of its first taxable year which begins after December 31, 1963. If a transaction to which section 381(a) of the code applies or a mere change in the form of conducting a trade or business (within the meaning of sec. 47(b) of the code) occurs before the increase in basis has been taken into account by the transferor, the increase in basis is taken into account by the transferee. For example, if calendar-year individual A, who placed section 38 property in service before January 1, 1964, transfers the section 38 property to calendar-year corporation X on September 1, 1963, in a transaction to which section 47(a) does not apply because such transaction constitutes a mere change in the form of conducting the trade or business, the increase in basis is to be taken into account by corporation X as of January 1, 1964.

The increase in basis is to be taken into account for purposes of computing depreciation deductions for the taxpayer's first taxable year which begins after December 31, 1963, and for all subsequent periods, and for purposes of computing gain or loss on the sale or other disposition of the property.

The provisions of paragraph (2)(A) of section 203(a) of the bill are illustrated by the following example:

Example.—X corporation, which makes its returns on the basis of the calendar year, acquires and places in service on January 1, 1962, an item of new section 38 property with a basis of $10,000 and an estimated useful life of 10 years. For the taxable year 1962, X is allowed a credit of $700 (7 percent of $10,000). Under section 48(g)(1) of the code, the basis of the property is reduced by $700. Under paragraph (2)(A) of section 203(a) of the bill, the basis of the property is increased on January 1, 1964, by $700 (7 percent of $10,000, the qualified investment). However, if such property had been sold by X on December 1, 1963, on such date the basis of such property is increased under section 48(g)(2) by $700, and there would be no further increase on January 1, 1964. If X was a partnership and if a partner had disposed of his partnership interest on December 1, 1963, and on such date the basis of such property had been increased under section 48(g)(2) by $500, the basis of the property would be increased on January 1, 1964, by only $200 ($700 minus $500). If X was an individual who died on December 1, 1963, there would be no increase under section 203(a)(2)(A) of the bill in the basis of such property.

Increase in rental deductions

Paragraph (2)(B) of section 203(a) of the bill provides that if, with respect to any section 38 property placed in service before January 1, 1964, a lessor made the election (provided by sec. 48(d) of the code) to treat the lessee as having purchased such property for purposes of the investment credit, the basis of such property is not to be increased under paragraph (2)(A) of section 203(a) of the bill. However, under regulations prescribed by the Secretary of

the Treasury or his delegate, the deductions otherwise allowable under section 162 of the code to the lessee with respect to such property for amounts paid to the lessor under the lease (hereinafter referred to as rental deductions) are to be adjusted in a manner consistent with paragraph (2)(A). The amount of the increase in rental deductions with respect to a leased property placed in service before January 1, 1964, may not exceed the sum of the actual decreases made (under the last sentence of sec. 48(d)) in the rental deductions with respect to such property. In determining the amount of the increase in such rental deductions, any prior increase in such deductions under the last sentence of section 48(d) because of the application of section 47(a) (in taxable years beginning before Jan. 1, 1964) is to be taken into account. The rental deductions with respect to any section 38 property are not to be increased under paragraph (2)(B) of section 203 (a) of the bill if the lessee dies in a taxable year beginning before January 1, 1964.

The amount of the increase in rental deductions with respect to a leased property is to be taken into account, commencing with the first taxable year beginning after December 31, 1963, over the remaining portion of the useful life used in making the decreases in rental deductions with respect to such property. Generally, if the lessee terminates the lease during this period, the portion of the increase which has not yet been taken into account is allowed as a deduction in the taxable year in which such termination occurs. If the lessee actually purchases the leased property during this period, the portion of the increase which has not yet been taken into account is added to the basis of the property at the date of purchase.

If a lessor of property makes the election under section 48(d) to treat the lessee as having purchased section 38 property for purposes of the investment credit and if such lessee in a taxable year beginning before January 1, 1964, actually purchases such property, the basis of such property is increased by 7 percent of the qualified investment with respect to such property (in a manner consistent with par. (2)(A) of sec. 203(a) of the bill) as of the first day of the first taxable year beginning after December 31, 1963.

The provisions of paragraph (2)(B) of section 203(a) of the bill are illustrated by the following example:

Example.—X corporation constructs a machine after December 31, 1961, and on February 1, 1962, leases the machine to Y, a calendar year taxpayer, who places it in service. The fair market value of the machine on the date on which possession is transferred to Y is $25,200 and the machine has an estimated useful life to X of 12 years. X elects to treat Y as the purchaser of the property for purposes of the investment credit. For purposes of computing qualified investment under section 46(c) of the code, the basis of the property to Y is $25,200 and Y's credit earned for 1962 with respect to such machine is $1,764 (7 percent of $25,200). Y's rental deductions with respect to such machine are decreased by $12.25 each month ($1,764 divided by 144 months). Under paragraph (2)(B) of section 203(a) of the bill, Y's rental deductions are increased by $281.75 ($12.25 multiplied by 23 months). Such increase is taken into account over the remaining 121 months of the useful life of the machine commencing with the taxable year 1964. If Y had actually purchased the machine from X on January 1, 1963, and had reduced the basis of the machine on such date by $1,629.25

($1,764 minus $134.75), the basis of such machine in Y's hands would be increased, on January 1, 1964, by $1,764 (7 percent of the qualified investment).

Certain leased property

Paragraph (3)(A) of section 203(a) of the bill repeals the last sentence of section 48(d) of the code. Under the last sentence of section 48(d), if a lessor makes an election to treat the lessee of section 38 property as having acquired such property for purposes of the investment credit, section 48(g) (relating to adjustments to basis) does not apply with respect to such property and the deductions otherwise allowable to the lessee under section 162 of the code for amounts paid to the lessor under the lease must be adjusted in a manner consistent with the provisions of section 48(g).

This repeal is effective (under par. (4) of sec. 203(a) of the bill), in the case of section 38 property placed in service after December 31, 1963, with respect to taxable years ending after December 31, 1963; and in the case of property placed in service before January 1, 1964, with respect to taxable years beginning after December 31, 1963. Thus, if lessor X elects to treat calendar year lessee Y, who placed section 38 property in service in July 1962, as the purchaser of the property for purposes of the investment credit, Y reduces his deductions for rental payments under section 162 of the code for his 1962 and 1963 taxable years, but does not reduce his rental deductions for any subsequent taxable year. If in December 1963 section 47(a) (1) or (2) of the code applies to increase Y's tax with respect to such property, Y's rental deductions with respect thereto are adjusted, under the last sentence of section 48(d), in a manner consistent with section 48(g)(2). However, if Y had placed the property in service on January 1, 1964, Y would not reduce or otherwise adjust his deductions for rental payments for any taxable year.

Deduction for certain unused investment credit

Paragraph (3)(B) of section 203(a) of the bill repeals section 181 of the code. Under section 181, if the amount of the credit earned for any taxable year exceeds the limitation provided by section 46(a)(2) (relating to limitation based on amount of tax) for such year and if any portion of such excess is not allowed as a credit after the application of the 3-year carryback and the 5-year carryover provisions, then the portion of such excess not so allowed as a credit in any of such taxable years is allowed to the taxpayer as a deduction in the sixth taxable year following the taxable year in which the credit was earned. Section 181 further provides that if a taxpayer dies or ceases to exist prior to such sixth taxable year, such taxpayer is allowed as a deduction, for the taxable year of such death or cessation, an amount equal to the proper portion of such excess.

This repeal is effective (under par. (4) of sec. 203(a) of the bill), in the case of section 38 property placed in service after December 31, 1963, with respect to taxable years ending after December 31, 1963; and in the case of property placed in service before January 1, 1964, with respect to taxable years beginning after December 31, 1963.

Adjustments to basis under section 1016

Paragraph (3)(C) of section 203(a) of the bill makes a technical amendment to section 1016(a)(19) of the code (relating to adjustments to basis).

Clerical amendment

Paragraph (3)(D) of section 203(a) of the bill amends the table of sections for part VI of subchapter B of chapter 1 of the code.

Effective date

Paragraph (4) of section 203(a) of the bill provides effective dates for the amendments made by paragraphs (1) and (3) of section 203(a). Paragraph (4)(A) provides that if the property involved is placed in service after December 31, 1963, then the amendments made by paragraphs (1) and (3) apply with respect to taxable years ending after December 31, 1963. Paragraph (4)(B) provides that if the property is placed in service before January 1, 1964, then the amendments made by paragraphs (1) and (3) apply with respect to taxable years beginning after December 31, 1963.

SECTION 204. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES

(*a*) *Inclusion in income.*—Subsection (a)(1) of section 204 of the bill (sec. 203 of the bill as passed by the House) adds a new section 79 to part II of subchapter B of chapter 1 of the code (relating to items specifically included in gross income).

SECTION 79. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES

(*a*) *General rule.*—The new section 79(a) has been approved by your committee with one change. In the bill as passed by the House, an exclusion was provided for the cost of the first $30,000 of group-term life insurance provided for an employee. Your committee has increased such exclusion to the cost of the first $70,000 of such insurance. For the technical explanation of the new section 79(a) of the code (other than the amendment made by your committee), see page A-29 of the report of the Committee on Ways and Means on the bill.

(*b*) *Exceptions.*—The new section 79(b) has been approved by your committee without change. For a technical explanation of this section, see page A-31 of the report of the Committee on Ways and Means on the bill.

(*c*) *Determination of cost of insurance.*—The new section 79(c) as passed by the House provides rules for determining the cost of group-term life insurance protection with respect to an employee. Your committee has modified this section to eliminate one of the two alternative methods of determining cost. As passed by the House, section 79(c) contains three paragraphs, paragraph (1), (2), and (3). Your committee has deleted paragraph (2) and has combined without substantive change the provisions contained in paragraphs (1) and (3) into section 79(c).

Uniform premium table method

Under the bill as passed by the House, paragraph (1) of section 79(c) provides that the cost of group-term life insurance protection on the life of an employee provided during any period is determined on the basis of uniform premiums (computed on the basis of 5-year age brackets) to be set forth in a table prescribed in regulations by the Secretary of the Treasury or his delegate. Your committee has made

this method the sole method of determining the cost of group-term life insurance with respect to any employee. Under the bill as amended by your committee, this method of determining cost is now set forth in the first sentence of the new section 79(c).

Policy cost method

Under the bill as passed by the House, paragraph (2) of section 79(c) provides that, in lieu of using the uniform premium table, the employer may elect, with respect to any employee, to determine the cost of such employee's group-term life insurance on the basis of the average premium cost under the policy for the ages included within the age bracket which is applicable to the employee under the provisions of paragraph (1). Your committee has deleted this provision from the bill.

Employed individuals over age 64

Under the bill as passed by the House, paragraph (3) of section 79(c) provides that in the case of an employee who has attained age 64, the prescribed cost cannot exceed the cost with respect to the individual if he were age 63. Under the bill as amended by your committee this provision is incorporated in the second sentence of the new section 79(c).

Example.—The operation of the new section 79 as amended by your committee may be illustrated by the following example. Assume that for a full taxable year an employee, age 52, is provided (under a policy carried by his employer) with $110,000 of group-term life insurance on his life and that his spouse is the beneficiary. Assume further that the uniform premium applicable at his age is $10.87 per $1,000 of protection and that the employee contributes $1 per $1,000 of protection. Based on these facts, the amount includible in the employee's income is computed as follows:

Total group-term life insurance protection	$110, 000
Less $70,000 exclusion	70, 000
	40, 000
Cost of $40,000 of insurance (40×$10.87)	434. 80
Less employee's contributions (110×$1)	110. 00
Amount includible in employee's gross income	324. 80

SECTION 204. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES—Continued

Full-time life insurance salesmen

Subsection (a)(3) of section 204 of the bill amends section 7701(a)(20) of the code to provide that a full-time life insurance salesman who is considered an employee for purposes of chapter 21 of the code shall also be considered an employee for purposes of the new section 79. This subsection has been approved by your committee with a clerical change.

Certain contributions by employees for group-term life insurance

Subsection (b) of section 203 of the bill as passed by the House added a new section 218 to part VII of subchapter B of chapter 1 of the code (relating to additional itemized deductions for individuals). Your committee has deleted this subsection from the bill.

(*b*) *Withholding.*—Subsection (b) of section 204 of the bill (subsec. (c) of sec. 203 of the bill as passed by the House) amends section 3401(a) of the code (relating to definition of wages) by adding a new paragraph (14) at the end thereof. Under this new paragraph (14), as passed by the House, the term "wages" (for purposes of withholding of income tax at source on wages) includes remuneration paid in the form of group-term life insurance on the life of an employee, but only to the extent that the cost of such insurance is includible in the employee's gross income under the provisions of section 79(a) of the code (added to the code by this section of the bill). Your committee has amended the new paragraph (14) to provide that the term "wages" (for purposes of withholding of income tax at source on wages) does not include remuneration paid in the form of group-term life insurance on the life of an employee. In lieu of the deleted withholding provision, your committee has provided an information reporting requirement.

(*c*) *Information reporting.*—Subsection (c)(1) of section 204 of the bill adds a new section 6052 to subpart C of part III of subchapter A of chapter 61 of the code (relating to information concerning transactions with other persons).

The new section 6052(a) provides that every employer who, during any calendar year, provides group-term life insurance on the life of an employee during part or all of such calendar year under a policy (or policies) carried directly or indirectly by such employer shall make a return according to the forms or regulations prescribed by the Secretary of the Treasury or his delegate setting forth the cost of such insurance and the name and address of the employee on whose life such insurance is provided, but only to the extent that the cost of such insurance is includible in the employee's gross income under section 79(a). For purposes of the new section 6052(a), the cost of group-term life insurance is determined with reference to the cost of the life insurance (computed as provided in sec. 79(c)) provided to the employee, without regard to the time when the premium is paid by the employer. Under the provisions of the new section 6052(a), each employer paying remuneration to an employee in the form of group-term life insurance determines the amount includible in such employee's gross income under section 79(a) of the code as if such employer were the only employer paying the employee remuneration in the form of such insurance. Thus, an employer computes the amount includible in the gross income of an employee by applying a full $70,000 exclusion, without regard to whether another employer may also be furnishing group-term life insurance for the same employee during the same period.

The new section 6052(b) provides that every employer making a return under subsection (a) is to furnish to each employee whose name is set forth in such return a written statement showing the cost of the group-term life insurance shown on such return. The written statement required under the preceding sentence is to be furnished to the employee on or before January 31 of the year following the calendar year for which the return under subsection (a) was made.

Your committee has also provided that the penalties imposed by section 6652(a) of the code (relating to penalty for failure to file certain information returns) and section 6678 of the code (relating to penalty for failure to furnish certain statements) are to apply in the

case of each failure to file, with respect to an employee, a return or statement required by the new section 6052. See paragraph (2) of section 204(c), and paragraph (2) of section 222(b), of the bill.

(*d*) *Effective dates.*—Subsection (d) of section 204 of the bill provides that the amendments made by subsections (a) and (c) of this section of the bill, and paragraph (2) of section 222(b) of the bill, apply with respect to group-term life insurance provided after December 31, 1963, in taxable years ending after such date. The amendment made by subsection (b) applies with respect to remuneration paid after December 31, 1963, in the form of group-term life insurance provided after such date.

SECTION 205. AMOUNTS RECEIVED UNDER WAGE CONTINUATION PLANS

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-35 of the report of the Committee on Ways and Means on the bill.

SECTION 206. EXCLUSION FROM GROSS INCOME OF GAIN ON SALE OR EXCHANGE OF RESIDENCE OF INDIVIDUAL WHO HAS ATTAINED AGE 65

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-36 of the report of the Committee on Ways and Means on the bill.

SECTION 207. DENIAL OF DEDUCTION FOR CERTAIN STATE, LOCAL, AND FOREIGN TAXES

Section 207 of the bill as passed by the House consisted of three subsections. Subsection (a) of such section 207 revised subsections (a), (b), and (c) of section 164 of the code (relating to deduction for taxes). Subsection (b) of such section 207 made a number of technical amendments to the code and subsection (c) thereof contained the effective date provisions.

Your committee has made changes in subsection (a) of section 207 of the bill which affect subsections (a) and (b) of section 164 of the code. Subsection (b) of section 207 of the bill, as passed by the House, has been approved by your committee without change. Your committee has changed subsection (c) of section 207 of the bill by adding a new paragraph (2) thereto.

For the technical explanation of section 207 of the bill (other than the amendments made by your committee), see page A-40 of the report of the Committee on Ways and Means on the bill.

Section 164(a) as amended

Subsection (a) of section 164 of the code, as amended by the bill as passed by the House, provided, in part, that the following taxes would be allowed as a deduction for the taxable year within which paid or accrued:

(1) State and local, and foreign, real property taxes.
(2) State and local personal property taxes.

(3) State and local, and foreign, income, war profits, and excess profits taxes.

(4) State and local general sales taxes.

Your committee has added to the foregoing list State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels and State and local taxes on the registration or licensing of highway motor vehicles and on licenses for the operation of highway motor vehicles. As a result of your committee's amendment, any State and local taxes within the scope of the amendment which are now deductible under section 164 remain so; any such taxes which are not presently deductible are not made deductible by such amendment.

Section 164(b) as amended

Your committee has added a new paragraph (5) to section 164(b) of the code, as amended by the bill as passed by the House, to provide a special rule in the case of separately stated general sales taxes and any tax on the sale of gasoline, diesel fuel, or other motor fuel. This provision corresponds to section 164(b)(2)(E) as passed by the House except that its scope has been broadened to apply to taxes on the sale of gasoline, diesel fuel, and other motor fuel. If a tax to which this special rule has application is imposed on the seller, but the amount of such tax is separately stated, then (as under existing law), to the extent that the amount so stated is paid by the consumer (otherwise than in connection with the consumer's trade or business) to his seller, such amount is treated as a tax imposed on, and paid by, such consumer.

Subsection (c) of section 207

Under the bill as passed by the House, paragraph (1) of section 164(c) of the code denied a deduction for taxes assessed against local benefits of a kind tending to increase the value of the property assessed, except for the portion of such taxes properly allocable to interest or maintenance charges. Such paragraph (1) retained the rules of present law now contained in paragraph (5) of section 164(b) of the code but did not retain the exception to those rules now contained in section 164(b)(5)(B) which allow the deduction of local benefit taxes levied by a special taxing district if the taxes meet the tests specified therein.

Your committee has made no change in the language of paragraph (1) of section 164(c) of the code as contained in the House bill. However, your committee has added a new paragraph (2) to section 207(c) of the bill which provides that section 164(c)(1), as amended, shall not prevent the deduction under section 164, of taxes levied by a special taxing district—

(1) which is described in section 164(b)(5) of the code (as in effect for a taxable year ending on Dec. 31, 1963), and

(2) which was in existence on December 31, 1963,

but only in the case of taxes levied for the purpose of retiring indebtedness which existed on December 31, 1963.

SECTION 208. PERSONAL CASUALTY AND THEFT LOSSES

This section has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-45 of the report of the Committee on Ways and Means on the bill.

SECTION 209. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS

(*a*) *Certain organizations added to additional 10-percent charitable limitation.*—Subsection (a) of section 209 of the bill as passed by the House has been approved by your committee without change. For the technical explanation of this subsection of the bill, see page A-47 of the report of the Committee on Ways and Means on the bill.

(*b*) *Limitation of unlimited charitable contribution deduction.*—Your committee has added a new subsection (b) to section 209 of the bill to provide a limitation on the existing unlimited charitable contribution deduction.

Existing law

An individual taxpayer is presently allowed an unlimited charitable contribution deduction if in the taxable year, and in 8 of the 10 preceding taxable years, the charitable contributions and income taxes paid by the taxpayer during such year exceed 90 percent of his taxable income computed without deduction for charitable contributions, personal exemptions, and net operating loss carrybacks. Under existing law, the charitable contributions which may be used to satisfy the 90-percent requirement include contributions to both publicly and privately supported organizations.

Changes made by your committee

Subsection (b) of section 209 of the bill, as reported, amends section 170(b)(1) of the code by redesignating subparagraph (D) as (E) and by inserting a new subparagraph (D). The new subparagraph provides that only contributions described in subparagraph (A) of section 170(b)(1) (i.e., contributions to those organizations to which the additional 10-percent limitation is applicable) will qualify as charitable contributions for purposes of the unlimited charitable contribution deduction provisions. In general, these organizations include churches, certain educational organizations, certain hospitals and medical research organizations, certain organizations affiliated with State colleges and universities, certain governmental units, and certain other publicly supported organizations. Thus, for taxable years begining after December 31, 1963, only contributions to such organizations shall be taken into account in determining whether the taxpayer has satisfied the 90-percent requirement of section 170(b)(1)(C) for the current taxable year and for those taxable years preceding the current taxable year which begin after December 31, 1963. Contributions not described in section 170(b)(1)(A), such as contributions to private foundations, will not qualify as charitable contributions for purposes of the unlimited charitable contribution deduction provisions.

The new section 170(b)(1)(D) also provides that for purposes of section 170(b)(1)(C), the amount of charitable contributions shall be determined without regard to new paragraph (5) of section 170(b) of the code (added by sec. 209(c) of the bill, as reported). Therefore, in determining whether a taxpayer has satisfied the 90-percent requirement of subparagraph (C) for a current taxable year which begins after December 31, 1963, and for those taxable years preceding the current taxable year which begin after December 31, 1963, contributions made in prior years, but which under the provisions of

new paragraph (5) are treated as having been paid in subsequent years, shall not be taken into account.

The new section 170(b)(1)(D) provides that section 170(b)(1)(C) shall apply only if the taxpayer so elects. Such election can only be made by those taxpayers who satisfy the requirements of section 170(b)(1)(C), as modified by new section 170(b)(1)(D). The time and manner of such election shall be prescribed under regulations promulgated by the Secretary of the Treasury or his delegate. If a taxpayer makes such election, subsection (a) of section 170 shall apply only with respect to contributions described in subparagraph (A) of section 170(b)(1). Thus, a taxpayer who elects to apply section 170(b)(1)(C) and thus to deduct contributions to a publicly supported charitable organization in excess of the generally applicable 30-percent limitation may not also deduct contributions which he makes to private foundations. In addition, the new section 170(b)(1)(D) provides that if a taxpayer elects to apply section 170(b)(1)(C), contributions made in the current taxable year, or in any prior taxable year, may not be treated under new paragraph (5) of section 170(b) of the code as having been made in the current taxable year or in any succeeding taxable year.

Effective date

New section 170(b)(1)(D) shall apply with respect to contributions which are paid in taxable years beginning after December 31, 1963.

(*c*) *Five-year carryover of certain charitable contributions made by individuals.*—Subsection (c) of section 209 of the bill, as reported, adds a new paragraph (5) to section 170(b) of the code (relating to limitations on charitable contribution deduction) to provide a carryover of certain excess contributions made by individuals.

Subparagraph (A) of new section 170(b)(5) provides, in general, that in the case of an individual, if the amount of charitable contributions described in paragraph (1)(A) of section 170(b) (relating to contributions to churches, certain educational organizations, certain hospitals and medical research organizations, certain organizations affiliated with State colleges or universities, certain governmental units, and certain other publicly supported organizations), payment of which is made within a taxable year, exceeds 30 percent of the taxpayer's adjusted gross income for such year (computed without regard to any net operating loss carryback to such year under section 172), such excess shall be treated as a charitable contribution described in paragraph (1)(A) paid in each of the 5 succeeding taxable years in order of time. However, with respect to any such succeeding taxable year, the amount which is to be treated as paid in such succeeding taxable year is limited to the extent of the lesser of two amounts: (*i*) the amount by which 30 percent of the taxpayer's adjusted gross income for such succeeding taxable year (computed without regard to any net operating loss carryback to such succeeding taxable year under section 172) exceeds the sum of the charitable contributions described in paragraph (1)(A) payment of which is made by the taxpayer within such succeeding taxable year (determined without regard to new paragraph (5)) and the charitable contributions described in paragraph (1)(A) payment of which was made in taxable years before the contribution year which are treated under this new rule as having been paid in such succeeding taxable year; or (*ii*) in the case of the first succeeding taxable year, the amount of such excess contribution, and in the

case of the second, third, fourth, or fifth succeeding taxable year, the portion of such excess not treated under new paragraph (5) as a charitable contribution described in paragraph (1)(A) paid in any taxable year intervening between the contribution year and such succeeding taxable year.

Under the provisions of new paragraph (5), no excess contribution carryover will be allowed with respect to contributions to organizations not described in subparagraph (A) of section 170(b)(1), such as private foundations.

The new paragraph (5) of section 170(b) does not apply with respect to estates or trusts.

The application of new paragraph (5) is illustrated by the following examples:

Example 1.—Taxpayer A has adjusted gross income for 1964 of $50,000. In 1964 A contributes $16,500 to a church and $1,000 to a private foundation. Under existing law, A could claim a charitable contribution deduction of $15,000 (30 percent of $50,000). Under the bill, as approved by your committee, A could claim a charitable contribution deduction of $15,000 in 1964 and would have a charitable contribution carryover of $1,500 (excess of $16,500 contribution to the church over 30 percent of adjusted gross income of $50,000) to succeeding taxable years. No carryover would be allowed with respect to the $1,000 contribution to the private foundation.

Example 2.—Assume the same facts as in example 1. Assume further that for 1965 A has adjusted gross income of $40,000, and in 1965 contributes $11,000 to a church and $400 to a private foundation. Under existing law, A could claim a charitable contribution deduction of $11,400. Under the bill, as approved, by your committee, $1,000 ($40,000×30 percent=$12,000−$11,000 contribution paid to church in 1965) of the $1,500 excess contribution to the church which was paid in 1964 would be treated as paid in 1965 and therefore A could claim a total charitable contribution deduction of $12,000 for 1965. The remaining $500 of the excess contribution paid to the church in 1964 would be available for purposes of computing the carryover from 1964 to 1966, 1967, 1968, and 1969. No carryover would be allowed with respect to the $400 contribution to the private foundation.

Subparagraph (B) of new section 170(b)(5) provides that in the application of subparagraph (A), the excess determined under such subparagraph for the contribution year shall be reduced to the extent that such excess reduces taxable income as computed for purposes of the second sentence of section 172(b)(2) (relating to amount of net operating loss carrybacks and carryovers) and increases the net operating loss deduction for a taxable year succeeding the contribution year. To prevent a double deduction which might arise from the interrelationship of the charitable contribution carryover and the net operating loss carryover, subparagraph (B) of new section 170(b)(5) provides, in effect, that an excess charitable contribution shall reduce taxable income only once.

Paragraph (2) of section 209(c) of the bill contains technical amendments. Section 545(b)(2) (relating to deductions for charitable contributions by personal holding companies) and section 556(b)(2) (relating to deductions for charitable contributions by foreign personal holding companies) are each amended, in effect, to provide that new

paragraph (5) of section 170(b) shall not apply for purposes of computing the deduction for charitable contributions provided under section 170 with respect to these organizations.

Effective date

New paragraph (5) of section 170(b) shall apply with respect to charitable contributions which are paid in taxable years beginning after December 31, 1963.

(*d*) *Five-year carryover of certain charitable contributions made by corporations.*—Subsection (b) of section 209 of the bill as passed by the House has been redesignated as subsection (d) and, with the exception of a change made in the effective date of this subsection, has been approved by your committee without change.

Under the bill as passed by the House, the 5-year corporate carryover applied only with respect to contributions which are paid (or treated as paid under sec. 170(a)(2) of the Internal Revenue Code of 1954) in taxable years beginning after December 31, 1963. Under the bill, as approved by your committee, the 5-year corporate carryover shall apply to taxable years beginning after December 31, 1963, with respect to contributions which are paid (or treated as paid under sec. 170(a)(2) of the Internal Revenue Code of 1954) in taxable years beginning after December 31, 1961.

For the technical explanation of this subsection of the bill, see page A-48 of the report of the Committee on Ways and Means on the bill.

(*e*) *Future interests in tangible personal property.*—Subsection (c) of section 209 of the bill as passed by the House has been redesignated as subsection (e) and has been approved by your committee with an amendment.

As passed by the House, a new subsection (f) was added to section 170 of the code. Section 170(a) of the code provides that a charitable contribution is allowable as a deduction for the taxable year during which payment thereof is made. The new section 170(f) adds a special rule to determine when a charitable contribution consisting of a future interest in tangible personal property is considered to be paid. Under the bill as reported, the new section 170(f) provides, in effect, that the gift of such an interest will be considered to be incomplete for so long as the contributor (or a person standing in a relationship to the contributor described in sec. 267(b) of the code (relating to losses, expenses, and interest with respect to transactions between related taxpayers)) retains an intervening interest or right to the actual possession or enjoyment of the property. Under this special rule, a charitable contribution of a future interest in tangible personal property is deemed paid only when (1) all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired, or (2) all intervening interests in, and rights to the actual possession or enjoyment of, the property are held by a person or persons other than the contributor or related parties.

The bill as passed by the House also contains an exception which was stated in the last two sentences of new subsection (f). Such exception provided that the special rule of section 170(f) does not apply to a contribution in which the sole intervening interest or right is a nontransferable interest reserved by the donor which expires upon the donor's death, or, in the case of a joint gift by husband and wife, the sole intervening interest or right is a nontransferable interest reserved by the donors which expires upon the death of whichever of such donors

dies later. However, the right to transfer the reserved life interest to the donee of the future interest (i.e., the charity which receives the future interest contributed) was not treated as making a life estate transferable.

New subsection (f), as approved by your committee, eliminates this exception.

The application of new subsection (f), as approved by your committee, may be illustrated by the following example. If a taxpayer contributes a remainder interest in a painting which he owns to a charity, reserving to himself the right to possession of the painting during his lifetime, the retention of the right to possession is treated as a postponement in the payment of such contribution until his right to possession terminates. Thus, if the taxpayer subsequently transfers his intervening right to possession to the charity, or to an unrelated person (a person who does not stand in a relationship to the donor which is set forth in sec. 267(b)), payment of the remainder interest is thereupon deemed to have been completed and the value of such interest (computed as of the date the contribution is deemed to have been completed) is allowed as a deduction, subject to the limitations imposed by subsection (b) of section 170, in the year the donor's intervening right to possession is transferred. On the other hand, if the taxpayer retains any right to possession of the painting until his death, he is not entitled to an income tax deduction with respect to the remainder interest transferred on any return during his lifetime or on his final return. However, the retention of the right to possession until death would result in the inclusion of the painting in the taxpayer's gross estate and a deduction for the included value would be allowed to his estate, as a charitable transfer, for estate tax purposes.

Effective date

The amendments made by subsection (e) of the bill shall apply to transfers of future interests made after December 31, 1963, in taxable years ending after such date.

SECTION 210. LOSSES ARISING FROM EXPROPRIATION OF PROPERTY BY GOVERNMENTS OF FOREIGN COUNTRIES

Section 210 of the bill, which is a new section added to the bill as passed by the House, amends section 172 of the code to provide a 10-year carryover of certain expropriation losses.

(*a*) *Net operating loss carryover.*—Under the existing section 172(b)(1) of the code, relating to years to which a net operating loss may be carried, generally a net operating loss for any taxable year is a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss and is a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

Paragraph (1) of section 210(a) of the bill, as added by your committee, amends subparagraph (A)(i) of section 172(b)(1) of the code, relating to years to which a net operating loss may be carried, to provide that the 3-year carryback rule does not apply to the portion of a net operating loss for a taxable year attributable to a foreign expropriation loss.

Paragraph (2) of section 210(a) of the bill, as added by your committee, amends subparagraph (B) of section 172(b)(1) of the code

to provide that the 5-year carryover rule does not apply to the portion of a net operating loss for a taxable year attributable to a foreign expropriation loss.

Paragraph (3) of section 210(a) of the bill, as added by your committee, amends section 172(b)(1), relating to years to which a net operating loss may be carried, by adding to such section a new subparagraph (D). The new subparagraph (D) of section 172(b)(1) of the code provides that in the case of a taxpayer which has a foreign expropriation loss for any taxable year ending after December 31, 1958, the portion of the net operating loss for such year attributable to such foreign expropriation loss shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 10 taxable years following the taxable year of such loss. The term "foreign expropriation loss" is defined in a new subsection (k) added to section 172 of the code by paragraph (5) of section 210(a) of the bill, as added by your committee.

Paragraph (4) of section 210(a) of the bill, as added by your committee, amends section 172(b)(3), relating to special rules for net operating loss carrybacks and carryovers, by adding to such section new subparagraphs (C) and (D). Clause (i) of the new subparagraph (C) provides that the new subparagraph (D) of section 172(b)(1) of the code which allows the portion of a net operating loss for a taxable year attributable to a foreign expropriation loss to be carried forward for 10 years shall apply only if the foreign expropriation loss for the taxable year equals or exceeds 50 percent of the net operating loss for the taxable year.

Clause (ii) of the new subparagraph (C) provides that, in the case of a foreign expropriation loss for a taxable year ending after December 31, 1963, the new 10-year carryover provision shall apply only if the taxpayer elects (at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes) to have such new subparagraph (D) of section 172(b)(1) of the code apply.

Clause (iii) of the new subparagraph (C) provides that, in the case of a foreign expropriation loss for a taxable year ending after December 31, 1958, and before January 1, 1964, the new 10-year carryover provision shall apply only if the taxpayer elects (in such manner as may be prescribed by the Secretary of the Treasury or his delegate) on or before December 31, 1965, to have such new subparagraph (D) of section 172(b)(1) of the code apply.

The new subparagraph (D) of section 172(b)(3) of the code provides that if a taxpayer makes an election under such subparagraph (C)(iii), then (notwithstanding any law or rule of law), with respect to any taxable year ending before January 1, 1964, affected by such election (1) the time for making or changing any choice or election under subpart A of part III of subchapter N (relating to foreign tax credit) shall not expire before January 1, 1966, (2) any deficiency attributable to the election under subparagraph (C)(iii) of section 172(b)(3) of the code or the application of clause (i) of section 172(b)(3)(D) of the code may be assessed at any time before January 1, 1969, and (3) refund or credit of any overpayment attributable to the election under subparagraph (C)(iii) of section 172(b)(3) of the code or the

application of clause (i) of section 172(b)(3)(D) of the code may be made or allowed if claim therefor is filed before January 1, 1969. In the event that the period within which a deficiency may be assessed or a claim for refund filed would expire at a date subsequent to January 1, 1969, under section 6501 or 6511 of the code, then such later date shall apply.

Paragraph (5) of section 210(a) of the bill, as added by your committee, amends section 172, relating to net operating loss deduction, by redesignating the existing subsection (k) as subsection (l) and by adding to such section a new subsection (k). The new subsection (k) provides that (1) the term "foreign expropriation loss" means, for any taxable year, the sum of the losses sustained with respect to property by reason of the expropriation, intervention, seizure, or similar taking of such property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing, and (2) the portion of the net operating loss for such year attributable to a foreign expropriation loss is the amount of the foreign expropriation loss for such year (but not in excess of the net operating loss for such year). The amount of any loss sustained is determined under section 165 of the code.

(*b*) *Technical amendments.*—Paragraph (1) of section 210(b) of the bill, as added by your committee, amends subparagraph (B) of section 172(b)(2) of the code, relating to amount of carrybacks and carryovers, by placing the existing provisions of such subparagraph (B) in a new subparagraph (B)(i) and by adding to such section a new subparagraph (B)(ii). Under existing section 172(b)(2) of the code the portion of a net operating loss which shall be carried to each of the taxable years other than the earliest taxable year to which such loss may be carried shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. The new subparagraph (B)(ii) provides that, in computing taxable income for any such prior taxable year, the amount of the net operating loss deduction shall be determined without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1)(D) of section 172(b) of the code, be carried back to such prior taxable year.

Paragraph (2) of section 210(b) of the bill, as added by your committee, amends section 172(b)(2), relating to amount of carrybacks and carryovers, by adding at the end of such section a new sentence. The new sentence provides, in effect, that the portion of a net operating loss for a loss year attributable to a foreign expropriation loss shall be considered to be a separate net operating loss for such loss year. Such portion attributable to a foreign expropriation loss is to be applied after the other portion of such net operating loss for such loss year, but prior to any net operating losses for subsequent taxable years.

(*c*) *Effective date.*—Subsection (c) of section 210 of the bill, as added by your committee, provides that the amendments made by such section 210 shall apply in respect of foreign expropriation losses sustained in taxable years ending after December 31, 1958.

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SECTION 211. ONE-PERCENT LIMITATION ON MEDICINE AND DRUGS

Section 211 of the bill (sec. 210 of the bill as passed by the House) has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-51 of the report of the Committee on Ways and Means on the bill.

SECTION 212. CARE OF DEPENDENTS

Section 212 of the bill (sec. 211 of the bill as passed by the House) amends section 214 of the code (relating to expenses for care of certain dependents). Subsections (a), (c), and (d) of section 214 of the code as amended by the bill as passed by the House and the effective date provision for this section of the bill have been approved by your committee without change. For the technical explanation of this section of the bill (other than the amendments made by your committee), see page A-52 of the report of the Committee on Ways and Means on the bill.

Subsection (b) of section 214, as amended by the bill as passed by the House, prescribed certain limitations on the allowability of the deduction otherwise authorized by subsection (a) of such section. The changes made by your committee in respect of these limitations are discussed below.

Dollar amount

Under the bill as passed by the House, subsection (b) of section 214 limited the deduction under section 214(a) to $600 for any taxable year except that such limit would be increased (to an amount not above $900) by the amount of expenses incurred by a taxpayer for any period during which the taxpayer had two or more dependents (within the meaning of amended sec. 214(d)(1) of the code). However, in the case of a woman who is married, the $600 limit would be increased only in respect of expenses incurred during a period while her husband was incapable of self-support because mentally or physically defective.

As amended by your committee, subsection (b) of section 214 limits the deduction under section 214(a) to $600 for any taxable year, except that such $600 limit—

(1) shall be increased (to an amount not above $900) by the amount of expenses incurred by the taxpayer for any period during which the taxpayer had two dependents (within the meaning of amended sec. 214(d)(1) of the code), and

(2) shall be increased (to an amount not above $1,000) by the amount of expenses incurred by the taxpayer for any period during which the taxpayer had three or more dependents (within the meaning of amended sec. 214(d)(1) of the code).

The provision of the bill as passed by the House dealing with the increase in the $600 limit in the case of a married woman (see the last sentence of the preceding paragraph) has been deleted.

Working wives and husbands with incapacitated wives

Under the bill as passed by the House, subsection (b) of section 214 further provided, in the case of a woman who is married and a husband whose wife is incapacitated, that the deduction otherwise allowable under section 214(a)—

(1) would not be allowed unless the couple files a joint return; and

(2) would be reduced dollar for dollar to the extent that the couple's combined adjusted gross income exceeds $4,500.

These conditions, however, were made inapplicable in certain specified situations.

The foregoing provisions of the bill as passed by the House have been approved by your committee and have been combined into one paragraph with an amendment providing that the deduction otherwise allowable under section 214(a) is to be reduced dollar for dollar to the extent that the couple's combined adjusted gross income exceeds $7,000 (rather than $4,500 as provided in the bill as passed by the House).

SECTION 213. MOVING EXPENSES

Section 213 of the bill (sec. 212 of the bill as passed by the House) has been approved by your committee except for a change in the effective date provision in subsection (d). The amendment made by subsection (c) of section 213 (relating to the definition of "wages" for withholding purposes) applied, under the bill as passed by the House, with respect to remuneration paid after December 31, 1963. As amended by your committee, such provision applies with respect to remuneration paid after the seventh day following the date of enactment of the bill.

For the technical explanation of this section of the bill, see page A-57 of the report of the Committee on Ways and Means on the bill.

SECTION 214. DEDUCTION FOR POLITICAL CONTRIBUTIONS

Section 214 of the bill, which is a new section added to the bill as passed by the House, relates to a deduction for certain political contributions in computing taxable income.

(a) *Allowance of deduction.*—Subsection (a) of section 214 of the bill amends part VII of subchapter B of chapter 1 (relating to additional itemized deductions for individuals) of the Internal Revenue Code of 1954 by inserting after section 217 (as added by sec. 213(a)(1) of the bill) a new section 218.

SECTION 218. CONTRIBUTIONS TO POLITICAL CANDIDATES AND POLITICAL COMMITTEES

Subsection (a) of section 218 allows an individual a deduction for any political contribution (as defined in subsec. (c)), payment of which is made during the taxable year. The deduction will be allowable only for the taxable year in which the contribution is paid. The method of accounting employed by the taxpayer and the time when the contribution is pledged are immaterial.

Subsection (b)(1) of section 218 limits the deduction under subsection (a) to an aggregate of $50 for any taxable year except that in the case of husband and wife filing a joint return, the deduction for any year is limited to $100. The amount of the deduction in the case of a joint return will not be affected even though the contributions are made by only one spouse.

Subsection (b)(2) of section 218 provides that the deduction under subsection (a) shall be allowed only if the political contribution is verified in accordance with regulations prescribed by the Secretary of the Treasury or his delegate.

The term "political contribution" is defined in subsection (c) of section 218 as a contribution or gift to a political candidate or a political committee for the purpose of furthering the candidacy of one or more individuals in a general, special, or primary election or in a convention of a political party. A contribution to an organization which engages in activities in addition to influencing the election of political candidates, such as general political education, could qualify if such contribution is made to further the candidacy of one or more individuals in a general, special, or primary election or in a convention of a political party and if the funds received from such contributions are segregated from funds for such other activities. The principles applicable under section 170 of the code (relating to charitable contributions) will be followed in determining what constitutes a contribution or gift and the amount thereof. Thus, only that portion of the cost of tickets to fund-raising dinners which represents the excess of the price of the ticket over the amount which would ordinarily be paid for the dinner will qualify as a contribution. In addition, the value of services rendered to a candidate or committee will not qualify as a contribution.

(*b*) *Technical amendment.*—Subsection (b) of section 214 of the bill amends section 642 of the code (relating to special rules for credits and deductions of estates and trusts) by redesignating subsection (i) as subsection (j) and inserting a new subsection (i) which provides that an estate or trust is not allowed the deduction for political contributions provided under section 218.

(*c*) *Effective date.*—Under subsection (c) of section 214 of the bill, only contributions or gifts payment of which is made on or after the date of the enactment of the bill in taxable years ending after such date will be allowable as a deduction under new section 218 of the code.

SECTION 215. 100 PERCENT DIVIDENDS RECEIVED DEDUCTION FOR MEMBERS OF ELECTING AFFILIATED GROUPS

Section 215 of the bill, which is a new section added to the bill as passed by the House, amends section 243 of the code (relating to the deduction for certain dividends received by corporations), and makes conforming technical amendments.

(*a*) *100 percent dividends received deduction.*—Subsection (a) of section 243, as amended, in substance incorporates the provisions of subsections (a) and (b) of existing section 243. Paragraph (1) of subsection (a) corresponds t' subsection (a) of existing section 243 and paragraph (2) of subsection (a) corresponds to subsection (b) of existing section 243. Paragraph (3) of subsection (a), which has no counterpart in existing law, provides for a 100 percent deduction in the case of "qualifying dividends."

Qualifying dividends

Subsection (b)(1) of section 243, as amended, defines the term "qualifying dividends" to mean dividends received by a corporation which, at the close of the day the dividends are received, is a member of the same affiliated group of corporations (as defined in par (5)

of sec. 243(b)) as the corporation distributing the dividends, provided that the conditions prescribed in subparagraphs (A) and (B) of section 243(b)(1) are met.

Subparagraph (A) of section 243(b)(1) provides that such affiliated group which includes the distributing and recipient corporations must have made an election (under par. (2) of sec. 243(b)) which is effective for the taxable years of its member corporations which include the day of receipt.

Subparagraph (B) of section 243(b)(1) provides that such dividends must have been distributed out of earnings and profits of a taxable year which ends after December 31, 1963, and with respect to which two requirements are satisfied. First, under clause (i) of subparagraph (B), on each day of such taxable year the distributing corporation and the recipient corporation must have been members of such affiliated group. Second, under clause (ii) of subparagraph (B), an election under section 1562 (relating to election of multiple surtax exemptions) must not be effective for such taxable year.

The application of the provisions of section 243(b)(1) may be illustrated by the following examples:

Example (1).—On March 1, 1964, corporation P, a publicly owned corporation, acquires all the stock of corporations S and S–1 and continues to hold such stock throughout the remainder of 1964 and all of 1965. Corporations P, S, and S–1 are domestic corporations which file separate returns on the basis of a calendar year. An election under section 1562 was not effective for their taxable years ending December 31, 1964, and December 31, 1965. Corporation S makes a $5,000 distribution with respect to its stock on February 1, 1965, which is received by corporation P on the same date. Before taking into account this distribution, corporation S had earnings and profits for its taxable years ending December 31, 1964, and December 31, 1965, of $7,000 and $4,000, respectively. An election under section 243(b)(2) is effective for the taxable years of corporations P, S, and S–1 which include February 1, 1965. Accordingly, corporation P will be entitled to a 100 percent dividends received deduction under section 243(a)(3) with respect to $4,000 of the $5,000 distribution received from corporation S on February 1, 1965. Since $1,000 of the $5,000 distribution was made out of earnings and profits of corporation S for its taxable year ending December 31, 1964, and since corporations P and S were not members of the same affiliated group of corporations on each day of such year, $1,000 of the February 1, 1965, distribution would not constitute a qualifying dividend as defined in section 243(b)(1) (but would constitute a dividend entitled to an 85 percent dividends received deduction under sec. 243(a)(1)).

Example (2).—Assume the same facts as in example (1), except that corporation P held all the stock of corporations S and S–1 on each day of 1964 and sold the stock of S on November 1, 1965. Since an election under section 243(b)(2) is effective for the taxable years of corporations P, S, and S–1 which include February 1, 1965, corporation P will be entitled to a 100 percent dividend received deduction under section 243(a)(3) with respect to $1,000 of the $5,000 distribution received from corporation S on February 1, 1965. The $1,000 amount represents the portion of the February 1, 1965, distribution which was made out of the earnings and profits of corporation S for its taxable year ending December 31, 1964, a year for which the

requirements of section 243(b)(1) are met. Since $4,000 of the $5,000 distribution was made out of the earnings and profits of corporation S for its taxable year ending December 31, 1965, and since corporations P and S were not members of the same affiliated group of corporations on each day of such year, $4,000 of the February 1, 1965, distribution would not constitute a qualifying dividend as defined in section 243(b)(1) (but would constitute a dividend entitled to an 85 percent dividends received deduction under sec. 243(a)(1)).

Election

Paragraph (2) of section 243(b), as amended, provides that an election (referred to in subpar. (A) of sec. 243(b)(1)) is to be made by the common parent corporation for the affiliated group of corporations. The election is to be made with respect to a particular taxable year of the common parent corporation and is to be made at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes. An election may not be made for an affiliated group for any taxable year of the common parent corporation for which an election under section 1562 (relating to election of multiple surtax exemptions) is effective. A consent is required from each corporation which is a member of the affiliated group at any time during its taxable year which includes the last day of the particular taxable year of the common parent corporation with respect to which the election is made. The consent is to be made at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes.

Under subparagraph (A) of paragraph (2), an election will be effective for the taxable year of each member of the affiliated group which includes the last day of the taxable year of the common parent corporation with respect to which the election is made. However, in the case of a taxable year of a member beginning in 1963 and ending in 1964, if an election is made with respect to a taxable year of the common parent corporation which includes the last day of such taxable year of such member, then the election will be effective with respect to such taxable year of such member if it consents to such election with respect to such taxable year. Under subparagraph (B) of paragraph (2), an election will also be effective (unless terminated under par. (4) of subsec. (b)) for the taxable year of each member which ends after the last day of the taxable year of the common parent corporation with respect to which the election is made but which does not include such last day.

The application of the provisions of section 243(b)(2) may be illustrated by the following example:

Example.—Corporation P is a common parent corporation of an affiliated group of corporations consisting of corporations P and S. Corporation P files its income tax return on the basis of a fiscal year ending June 30 and corporation S uses a calendar year as the basis for its tax return. Corporation P makes an election under section 243(b)(2) with respect to its taxable year ending June 30, 1965. If the election is properly consented to by P and S, the election will be effective with respect to the fiscal year of corporation P ending June 30, 1965, and with respect to the calendar year of corporation S ending December 31, 1965 (the year including June 30, 1965, the last day of the common parent corporation's taxable year with respect to

which the election was made). Further, if corporation Y, which has a fiscal year ending September 30, becomes a member of such affiliated group on June 15, 1966, the election will be effective with respect to corporation Y's taxable year ending September 30, 1966, as well as P's taxable year ending June 30, 1966, and S's calendar year ending December 31, 1966, unless the election is terminated under paragraph (4) of section 243(b).

Effect of election

Paragraph (3) of section 243(b), as amended, provides that if an election, made for an affiliated group of corporations under paragraph (2) of section 243(b), is effective with respect to any taxable year of the common parent corporation, then under regulations prescribed by the Secretary of the Treasury or his delegate—

(1) no member of such affiliated group may consent to an election under section 1562 for such taxable year;

(2) the members of such group will be treated as one taxpayer for purposes of making the elections under section 901(a) (relating to allowance of foreign tax credit) and section 904(b)(1) (relating to election of overall limitation); and

(3) the members of such affiliated group will be limited to (i) one $100,000 mimimum accumulated earnings credit under section 535(c) (2) or (3); (ii) one $100,000 limitation for exploration expenditures under section 615 (a) and (b); (iii) one $400,000 limitation for exploration expenditures under section 615(c)(1); (iv) one $25,000 limitation on small business deductions of life insurance companies under sections 804(a)(4) and 809(d)(10); and (v) one $100,000 exemption for purposes of estimated tax filing requirements under section 6016 and the addition to tax under section 6655 for failure to pay estimated tax.

Termination

Paragraph (4) of section 243(b), as amended, provides for the termination of an election under paragraph (2). Such termination, if made, is effective with respect to a taxable year of the common parent corporation and with respect to the taxable years of the members of the affiliated group which includes the last day of such taxable year of the common parent corporation. Under subparagraph (A) of paragraph (4), an election will be terminated if the affiliated group files, with respect to a particular taxable year of the common parent corporation, a termination of such election (at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes). Each corporation which is a member of the affiliated group at any time during its taxable year which includes the last day of such taxable year of the common parent corporation must consent to the termination of the election.

Under subparagraph (B) of paragraph (4), an election will be terminated with respect to a taxable year of the common parent corporation if with respect to such year the affiliated group includes a member which was not a member of such group during such common parent corporation's immediately preceding taxable year, and if such member files a statement that it does not consent to the election at such time and in such manner as the Secretary of the Treasury or his delegate by regulations prescribes.

Definition of affiliated group

Paragraph (5) of section 243(b), as amended, defines the term "affiliated group" for purposes of subsection (b) of section 243. The term is to have the same meaning assigned to it by section 1504(a) except that section 1504(b)(2) and section 1504(c) will not apply. Thus, for purposes of section 243(b), an affiliated group includes those domestic corporations (including a corporation which is treated as a domestic corporation under sec. 1504(d)) which meet the stock-ownership test contained in section 1504(a), and which are "includible corporations" within the meaning of section 1504(b); however, any domestic insurance company subject to taxation under section 802 or 821 will be treated for this purpose as an includible corporation.

Special rules for insurance companies

Paragraph (6) of section 243(b), as amended, provides special rules for certain insurance companies. Subparagraph (A) of paragraph (6) provides that if an election under subsection (b) of section 243 is effective for the taxable year of an insurance company subject to taxation under section 802 or 821 of the code, then part II of subchapter B of chapter 6 of the code (relating to certain controlled corporations) will be applied without regard to section 1563(a)(4) (relating to certain insurance companies) and section 1563(b)(2)(D) (relating to certain excluded members) with respect to such company and the other corporations which are members of the controlled group of corporations (as determined under sec. 1563 without regard to subsecs. (a)(4) and (b)(2)(D)) of which such company is a member. Subparagraph (B) of paragraph (6) provides that if an insurance company subject to taxation under section 802 or 821 distributes a dividend out of earnings and profits of a taxable year with respect to which the company would have been a component member of a controlled group of corporations within the meaning of section 1563 except for subsection (b)(2)(D) thereof, such dividend will not be treated as a qualifying dividend unless an election under subsection (b) of section 243 is effective for such taxable year.

The application of the provisions of paragraph (6) of section 243(b) may be illustrated by the following example:

Example.—Throughout 1965 corporation M owns all the stock of corporations L, X, and Y. Corporation M is a domestic mutual insurance company subject to tax under section 821 of the code, corporation L is a domestic life insurance company subject to tax under section 802 of the code, and corporations X and Y are subject to tax under section 11 of the code. Each corporation uses the calendar year for its taxable year. Corporation L pays a dividend to corporation M in 1965 which is out of the earnings and profits of L's taxable year ending on December 31, 1965. Corporation M makes an election under section 243(b)(2) for 1965 for the affiliated group consisting of corporations M, L, X, and Y which is properly consented to by such corporations. The application of paragraph (6) of section 243(b) results in the following tax consequences:

(1) As a result of applying part II of subchapter B of chapter 6 in the manner described in subparagraph (A) of section 243(b)(6), corporations M, L, X, and Y will be limited to a single $25,000 surtax exemption for their taxable years ending December 31, 1965 (to be apportioned among such corporations in accordance with sec. 1561).

Although M and L are excluded members of the controlled group of corporations consisting of corporations M, L, X, and Y, by reason of the application of the excluded member rule contained in subparagraph (D) of section 1563(b)(2), subparagraph (A) of section 243(b)(6) requires that part II of subchapter B of chapter 6 of the code be applied with respect to M and L and the other members of the controlled group without regard to such rule.

(2) The distribution by corporation L to corporation M is a qualifying dividend within the meaning of paragraph (1) of section 243(b). Since the distribution is out of the earnings and profits of L for its taxable year ending December 31, 1965 (a year in which L would have been a component member of a controlled group of corporations within the meaning of sec. 1563 except for the excluded member rule contained in subsec. (b)(2)(D)), and an election under paragraph (2) of section 243(b) is in effect for such taxable year, the dividend is not disqualified by operation of subparagraph (B) of section 243(b)(6).

Subsection (c) of section 243, as amended, includes a new paragraph (4). New paragraph (4) provides that any dividend received which is described in section 244 (relating to dividends received on preferred stock of a public utility), as amended by subsection (b)(1) of this section of the bill, shall not be treated as a dividend for purposes of section 243, as amended. The corresponding provisions of existing law appear as parenthetical phrases in existing subsections (a) and (b) of section 243.

Subsection (d) of section 243, as amended, is the same as existing section 243(d) except for a conforming change.

(*b*) *Technical amendments.*—Subsection (b) of section 215 of the bill makes technical amendments to several sections of the code to conform them to the amendments made by subsection (a) of this section of the bill.

(*c*) *Effective date.*—Subsection (c) of section 215 of the bill provides that the amendments made by subsections (a) and (b) of such section shall apply with respect to dividends received in taxable years ending after December 31, 1963.

SECTION 216. INTEREST ON LOANS INCURRED TO PURCHASE CERTAIN INSURANCE AND ANNUITY CONTRACTS

Section 216 of the bill (section 213 of the bill as passed by the House) amends section 264 of the code to provide that, under certain circumstances, no deduction is allowed for interest on loans incurred or continued to purchase or carry certain life insurance, endowment, or annuity contracts. For a technical explanation of this section of the bill (other than the amendment made by your committee), see page A-60 of the report of the Committee on Ways and Means on the bill.

Subsection (a)(2) of this section of the bill as passed by the House provided that new paragraph (3) of section 264(a) of the code (added by subsec. (a)(1) of sec. 216 of the bill) would apply only in respect of contracts purchased after August 6, 1963. Under your committee's amendment, new paragraph (3) of section 264(a) of the code applies only in respect of contracts purchased after December 31, 1963.

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SECTION 217. INTEREST ON INDEBTEDNESS INCURRED OR CONTINUED TO PURCHASE OR CARRY TAX-EXEMPT BONDS

Section 217 of the bill, which is a new section added to the bill as passed by the House, amends section 265(2) of the code by adding a new sentence at the end thereof.

Section 265(2) presently provides that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations (other than certain obligations of the United States) the interest from which is wholly exempt from the taxes imposed by subtitle A of the code (relating to income taxes).

(*a*) *Application with respect to certain financial institutions.*—Section 217(a) limits the application of section 265(2) in the case of interest expense in respect of face-amount certificates issued by a financial institution (other than a bank) which is subject to the banking laws of the State in which such institution is incorporated. The amendment does not affect the application of section 265(2) in the case of banks.

Under section 265(2), as amended, interest expense incurred by such an institution—

(1) on face-amount certificates (as defined in sec. 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C. 80a-2)) issued by the institution, and

(2) on amounts received by such institution to be applied toward the purchase of such face-amount certificates to be issued by the institution

is not to be considered as interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by subtitle A of the code to the extent that the average amount of such obligations held by such institution during the taxable year does not exceed 25 percent of the average of the total assets of the institution during the taxable year.

The Secretary of the Treasury or his delegate is required to prescribe by regulations the manner of computing the average amount of tax-exempt obligations held by such institution during the taxable year, and the manner of determining the average amount of the total assets held by such institution during the taxable year.

The computation of the average amount of tax-exempt obligations and the average amount of total assets is to be made not more frequently than weekly. Thus, if the Secretary or his delegate prescribes that such averages are to be computed as of the end of each week of the institution's taxable year, the percentage which the average amount of tax-exempt obligations is of the average amount of total assets of the institution for any taxable year shall be computed by dividing—

(1) the sum of the investments of the institution, as of the end of each week of its taxable year, in obligations the interest on which is wholly tax-exempt, by

(2) the sum of the total assets of the institution as of the end of each week of its taxable year.

If this computation results in a percentage figure in excess of 25 percent, there is interest on indebtedness which is subject to the first sentence of section 265(2). The amount thereof is obtained by multi-

plying the total interest expense for the taxable year on face-amount certificates and on amounts received for the purchase of such certificates by the percentage equal to the excess of such percentage figure over 25 percent.

In addition, any other interest expense of such institution is subject to the first sentence of section 265(2).

(*b*) *Effective date.*—Section 217(b) provides that the amendment made by section 217(a) shall apply with respect to taxable years ending after the date of enactment of the bill.

SECTION 218. REPEAL OF REQUIREMENT OF ALLOCATION OF CERTAIN TRAVELING EXPENSES

(*a*) *Repeal of section 274(c).*—Subsection (a) of section 218 of the bill, which is a new section added to the bill as passed by the House, amends section 274 of the code by repealing subsection (c) thereof. Section 274(c) provides that in the case of any individual who is traveling away from home in pursuit of a trade or business or in pursuit of an activity described in section 212, no deduction shall be allowed under section 162 or section 212 for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary of the Treasury or his delegate, is not allocable to such trade or business or to such activity. Such provision, however, does not apply to the expenses of any travel away from home which does not exceed 1 week or where the portion of the time away from home which is not attributable to the pursuit of the taxpayer's trade or business or to an activity specified in section 212 is less than 25 percent of the total time away from home on such travel.

(*b*) *Effective date.*—Subsection (b) of section 218 of the bill provides that the repeal made by this section shall apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date.

SECTION 219. ACQUISITION OF STOCK IN EXCHANGE FOR STOCK OF CORPORATION WHICH IS IN CONTROL OF ACQUIRING CORPORATION

(*a*) *Definition of reorganization.*—Subsection (a) of section 219 of the bill, which is a new section added by your committee to the bill as passed by the House, amends subparagraph (B) of section 368(a)(1) of the code, relating to definition of a stock-for-stock reorganization. Under the existing section 368(a)(1)(B), the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation qualifies as a "reorganization" if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

Subparagraph (B) of section 368(a)(1) of the code, as amended by this section of the bill, allows an acquiring corporation to exchange either its voting stock or the voting stock of a corporation which is in control of the acquiring corporation for the stock of another corporation.

(b) *Technical amendments.*—Paragraph (1) of section 219(b) of the bill, as added by your committee, amends subparagraph (C) of section 368(a)(2) of the code, relating to special rules. Under the existing section 368(a)(2)(C), a transaction otherwise qualifying as a "reorganization" under subparagraph (A) or (C) of section 368(a)(1), which relate respectively to statutory mergers or consolidations and stock-for-property reorganizations, is not disqualified by reason of the fact that part or all of the assets which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets.

Subparagraph (C) of section 368(a)(2) of the code, as amended by this section of the bill, allows a corporation acquiring stock in a transaction otherwise qualifying as a "reorganization" under section 368(a)(1)(B), as amended by this section of the bill, to transfer part or all of such stock to a corporation controlled by the corporation acquiring such stock.

Paragraph (2) of section 219(b) of the bill, as added by your committee, amends the last two sentences of subsection (b) of section 368, relating to definition of a party to a reorganization.

The next to last sentence of section 368(b) of the code, as amended by this section of the bill, provides that in the case of a reorganization qualifying under subparagraph (B) or (C) of section 368(a)(1), if the stock exchanged for the stock or properties is stock of a corporation which is in control of the acquiring corporation, the term "a party to a reorganization" includes the corporation so controlling the acquiring corporation. The last sentence of the amended section 368(b) of the code provides that in the case of a reorganization qualifying under subparagraph (A), (B), or (C) of section 368(a)(1) by reason of subparagraph (C) of section 368(a)(2), the term "a party to a reorganization" includes the corporation controlling the corporation to which the acquired assets or stock are transferred.

(c) *Effective date.*—Subsection (c) of section 219 of the bill, as added by your committee, provides that the amendments made by such section shall apply with respect to transactions after December 31, 1963, in taxable years ending after such date.

SECTION 220. RETROACTIVE QUALIFICATION OF CERTAIN UNION-NEGOTIATED MULTIEMPLOYER PENSION PLANS

(a) *Beginning of period as qualified trust.*—Subsection (a) of section 220 of the bill, which is a new section added by your committee to the bill as passed by the House, amends section 401 of the code by redesignating subsection (i) as (j), and by inserting a new subsection (i). Section 401 relates to qualified pension, profit-sharing, and stock bonus plans.

In general, under existing law, employer contributions to a pension trust are deductible only under the provisions of section 404 of the code. Deductibility under that section in effect requires, if the employees do not have a nonforfeitable right to the contributions at the time they are made, that the trust be part of a pension plan of an employer which qualifies under section 401(a) of the code. One of the requirements for qualification included in the Treasury Department's regulations under that section is that the plan be in

the form of "a definite written program and arrangement which is communicated to the employees." However, under a multiemployer collective bargaining agreement, employer contributions are often made to or for a pension trust before a complete schedule of benefits has been adopted, so that such contributions are not made to a qualified trust and, if not vested, are not deductible.

The new subsection (i) applies to a trust forming part of a pension plan which has been determined by the Secretary of the Treasury or his delegate to constitute a qualified trust under section 401(a), and to be exempt from taxation under section 501(a), for a period beginning after contributions were first made to or for such trust. The new subsection (i) provides that where such a trust meets certain conditions, then it shall be considered as having constituted a qualified trust under section 401(a), and as having been exempt from taxation under section 501(a), for the period beginning on the date on which contributions were first made to or for such trust and ending on the date such trust first constituted (without regard to the new subsection) a qualified trust.

The conditions referred to in the preceding paragraph require that it be shown to the satisfaction of the Secretary of the Treasury or his delegate that: (1) such trust was created pursuant to a collective bargaining agreement between employee representatives and two or more employers who are not related (determined under regulations prescribed by the Secretary of the Treasury or his delegate); (2) any disbursements made prior to the period for which the trust was determined to be qualified (without regard to the new subsection) substantially comply with the terms of the trust (and plan) as so qualified; and (3) prior to the period for which the trust was determined to be qualified (without regard to the new subsection) contributions were not used in a manner which jeopardized the interests of the beneficiaries.

In some cases, employer contributions are held in escrow until such time as a trust is created. For purposes of applying the new subsection (i), such employer contributions which are held in escrow and later transferred to a qualified trust are "contributions made to or for such trust."

(*b*) *Effective date.*—Subsection (b) of section 220 of the bill provides that the amendments made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954, but only with respect to contributions made after December 31, 1954. However, no provision of this section extends the period of limitations within which a claim for credit or refund may be filed for any taxable year.

SECTION 221. QUALIFIED PENSION, ETC., PLAN COVERAGE FOR EMPLOYEES OF CERTAIN SUBSIDIARY EMPLOYERS

Section 221 of the bill, which is a new section added to the bill as passed by the House, relates to the provision of qualified pension, profit-sharing, etc., plan coverage for certain employees of subsidairy corporations.

(*a*) *Employees of foreign subsidiaries covered by social security agreements.*—Subsection (a) of section 221 of the bill adds a new section 406 to part I of subchapter D of chapter 1 of the Internal Revenue

Code of 1954 (relating to pension, profit-sharing, stock bonus plans, etc.). The new section 406 relates to qualified pension, profit-sharing, etc., plan coverage for certain employees of foreign subsidiaries.

SECTION 406. QUALIFIED PENSION, PROFIT SHARING, ETC., PLAN COVERAGE FOR CERTAIN EMPLOYEES OF FOREIGN SUBSIDIARIES

(a) *Treatment as employees of domestic corporation.*—The new section 406(a) sets forth the rules relating to the treatment of certain employees of foreign subsidiaries who are covered under a social security agreement described in section 3121(l) of the code, entered into at the request of the domestic corporation, as employees of such domestic corporation. The new section 406(a) only applies in the case of a plan established and maintained by a domestic corporation which is a pension, profit-sharing, or stock bonus plan described in section 401(a) of the code, an annuity plan described in section 403(a) of the code, or a bond purchase plan described in section 405(a) of the code. The new section 406(a) provides that in the case of such a plan an individual who is a citizen of the United States and who is also an employee of a foreign subsidiary (as defined in section 3121(l)(8) of the code) of the domestic corporation shall be treated as an employee of such domestic corporation if certain requirements are satisfied. Under the new section 406(a), the deemed employer-employee relationship can only exist if the plan of the domestic employer is qualified. However, if the plan of the domestic employer is qualified, then the fact that the trust which forms a part of such plan is not exempt from tax under section 501(a) of the code does not affect such employer-employee relationship.

The first of the requirements of the new section 406(a) is that the domestic corporation has entered into an agreement described in section 3121(l) of the code, relating to agreements entered into by domestic corporations with respect to foreign subsidiaries, and such agreement covers the foreign subsidiary of the domestic corporation in which the individual is employed. Therefore, there is brought into play, as a condition precedent to obtaining the benefits of section 406, the rules set forth in section 3121(l) which relate to the circumstances under which a domestic corporation may enter into an agreement for the purpose of extending the benefits provided by title II of the Social Security Act to certain services performed outside the United States, and to the obligations of the domestic corporation which enters into such an agreement.

The second requirement is that the qualified plan of the domestic employer must expressly provide coverage for the U.S. citizen employees of all foreign subsidiaries which are covered under the agreement described in section 3121(l) of the code which has been entered into by the domestic corporation. However, such requirement does not modify the requirements for qualification set forth in section 401(a) of the code which are applicable to such plan. Thus, such plan must satisfy the requirements of section 401(a) after such plan is amended to cover individuals who are employees within the meaning of section 406(a). The plan need not provide actual benefits for all citizen employees of all such foreign subsidiaries; for example, some such employees may not receive benefits if they are excluded by reason of a nondiscriminatory classification or other provision of the plan.

The third requirement for qualification of an individual as an employee is that contributions under a funded plan of deferred compensation are not provided by any other person with respect to the remuneration paid to such individual by the foreign subsidiary. Contributions are provided under a funded plan of deferred compensation; for example, if contributions are provided for such individual under a plan described in section 401(a) of the code, section 403(a) of the code, or section 405(a) of the code. If any portion of such remuneration is covered under another plan by a person other than the domestic parent, such employee cannot be treated as the employee of the domestic corporation.

(*b*) *Special rules for application of section 401(a).*—The new section 406(b) provides certain special rules for the application of section 401(a) of the code in the case of a plan which covers an individual who is treated as an employee of a domestic corporation under the new section 406(a).

Paragraph (1) of such section 406(b) provides certain rules regarding the application of section 401(a) (3)(B) and (4) of the code in the case of a plan which covers such an individual. Paragraph (1)(A) of section 406(b) provides that if such an individual is an officer, shareholder, or person whose principal duties consist in supervising the work of other employees of a foreign subsidiary of such domestic corporation, he shall be treated as having such capacity with respect to the domestic corporation. Thus, for example, if an individual who is an employee within the meaning of section 406(a) is an officer of a foreign subsidiary, he is considered to be an officer of the domestic corporation treated as his employer for the purpose of determining whether the plan of such domestic employer satisfies the nondiscrimination requirements of section 401(a) (3)(B) and (4).

Paragraph (1)(B) of section 406(b) provides that the determination of whether an individual who is treated as an employee under the new section 406(a) is a highly compensated employee for purposes of section 401(a) (3)(B) and (4) of the code is made by treating such individual's total compensation (as computed in accordance with the provisions of par. (2) of sec. 406(b)) as compensation paid by the domestic corporation and by determining such individual's status as a highly compensated employee with regard to such domestic corporation.

Paragraph (2) of the new section 406(b) sets forth the rules regarding determination of the compensation of an individual who is treated as an employee of a domestic corporation under section 406(a) of the code. Such rules are applicable whenever the compensation of such an individual is to be determined for the purpose of determining whether the plan satisfies the requirements for qualification set forth in section 401(a). Paragraph (2)(A) of section 406(b) provides that, for the purpose of applying section 401(a)(5) with respect to such an individual, his total compensation is the remuneration paid to him by the foreign subsidiary which would constitute his total compensation if his services had been performed for the domestic corporation treated as his employer. In addition, such paragraph (2)(A) provides that the portion of the individual's total compensation which constitutes his basic or regular rate of compensation shall be determined under regulations prescribed by the Secretary of the Treasury or his delegate.

Paragraph (2)(B) of section 406(b) provides that an individual who is treated as an employee under section 406(a) shall be treated as having paid the amount paid by such domestic corporation which is equivalent to the tax imposed by section 3101 of the code (relating to the tax imposed on employees) with respect to such individual. Thus, the administrative rules relating to the determination of the contributions or benefits provided by the employer under the Social Security Act apply for purposes of determining whether the plan meets the requirements of section 401.

(*c*) *Termination of status as deemed employee not to be treated as separation from service for purposes of capital gains provisions.*—The new section 406(c) provides that the termination of status as an employee within the meaning of section 406(a) shall not be treated as separation from service for purposes of sections 402(a)(2) and 403(a)(2) of the code which provide capital gains treatment for certain distributions which take place after an employee's separation from the service. Section 406(c) provides that for purposes of applying section 402(a)(2) and section 403(a)(2) with respect to the distribution of the total amounts payable to an individual who is treated as an employee of a domestic corporation under section 406(a), such individual is not treated as separated from the service of the domestic corporation solely by reason of the occurrence of certain events.

The provisions of section 406(c) are in addition to the rules of existing law regarding the determination as to whether an employee is separated from service. In general, these provisions take into account the deemed employer-employee relationship which is established under the new section 406 of the code and provide that the termination of such deemed relationship does not result in a separation from service.

Section 406(c) provides that for purposes of applying section 402(a)(2) and section 403(a)(2) of the code with respect to an individual who is treated as an employee of a domestic corporation under section 406(a), such individual shall not be treated as separated from the service solely by reason of the fact that—

(1) The agreement entered into by such domestic corporation under section 3121(l) which covers the employment of such individual is terminated under the provisions of such section;

(2) Such individual becomes an employee of a foreign subsidiary (as defined in sec. 3121(l)(8)) with respect to which an agreement described in section 3121(l) does not apply;

(3) Such individual ceases to be an employee within the meaning of section 406(a) and becomes an employee of another corporation controlled by the domestic corporation; or

(4) The provision of the plan described in section 406(a)(2) is terminated.

For purposes of paragraph (3), above, a corporation is considered to be controlled by a domestic corporation if such domestic corporation owns directly or indirectly more than 50 percent of the voting stock of the corporation.

(*d*) *Deductibility of contributions.*—The new section 406(d) relates to the deductibility of contributions made on behalf of an individual who

is treated as an employee of a domestic corporation by reason of the provisions of section 406(a). The new section 406(d) provides that for purposes of applying sections 404 and 405(c) with respect to contributions made to a qualified plan on behalf of an individual who is treated as an employee of a domestic corporation under section 406(a), no domestic corporation is allowed a deduction. The amount which would be deductible under section 404 or 405(c) by the domestic corporation if the individual who is an employee within the meaning of section 406(a) were its own employee is allowed as a deduction to the foreign subsidiary. Thus, the foreign subsidiary is allowed the deduction under section 404(a) or 405(c), but such deduction is available to the foreign corporation only to the extent otherwise allowed under chapter 1 (see, for example, sec. 863 of the code).

Whether contributions on behalf of an individual who is treated as an employee under section 406(a), or forfeitures with regard to such employee, will result in an inclusion in the income of the domestic corporation, or an adjustment in the basis of such corporation's stock in the foreign corporation, will depend upon the rules of existing law. For example, an unreimbursed contribution by the domestic parent corporation to a plan under which each employee's rights to the contributions are nonforfeitable, will be treated as a contribution of capital to the foreign subsidiary to the extent that such contributions are made on behalf of such subsidiary's employees.

Paragraph (3) of the new section 406(d) provides that for the purpose of computing the amount deductible under section 404 or 405(c) any reference to compensation shall be considered to be a reference to the total compensation of such individual determined with the application of the rules set forth in the new section 406(b)(2).

The new section 406(d) also provides that any amount deductible by a foreign subsidiary under this section shall be deductible for its taxable year with or within which the taxable year of the domestic corporation ends.

(e) *Treatment as employee under related provisions.*—The new section 406(e) provides that, for purposes of applying certain related provisions of the code, an individual who is treated as an employee of a domestic corporation under the new section 406(a) is also to be treated as an employee of the domestic corporation with respect to certain related provisions dealing with the tax treatment of qualified plans. This section permits employees of subsidiaries covered under the qualified plan of the domestic corporation and their beneficiaries to receive the same tax treatment afforded other employees of such corporation and their beneficiaries with respect to the taxation of annuities, the death benefit exclusion, the exemption from gross estate of annuities under certain trusts and plans, and the exclusion from gift tax in the case of certain annuities under qualified plans. The provisions specifically designed under subsection (e) are: (1) Section 72(d), relating to employees' annuities; (2) section 72(f), relating to special rules for computing employees' contributions; (3) section 101(b), relating to employees' benefits; (4) section 2039, relating to annuities; and (5) section 2517, relating to certain annuities under qualified plans.

SECTION 221. QUALIFIED PENSION, ETC., PLAN COVERAGE FOR EMPLOYEES OF CERTAIN SUBSIDIARY EMPLOYERS—Continued

(*b*) *Employees of domestic subsidiaries engaged in business outside the United States.*—Subsection (b) of section 221 of the bill amends part I of subchapter D of chapter 1 of the code (relating to pension, profit-sharing, stock bonus plans, etc.) by adding after section 406 of the code a new section 407. The new section 407 relates to certain employees of domestic subsidaries engaged in business outside the United States.

SECTION 407. CERTAIN EMPLOYEES OF DOMESTIC SUBSIDIARIES ENGAGED IN BUSINESS OUTSIDE THE UNITED STATES

(*a*) *Treatment as employees of domestic parent corporation.*—The new section 407(a) sets forth the requirements which must be satisfied for a U.S. citizen who is employed by a domestic subsidiary engaged in business outside the United States to be treated as an employee of the domestic parent corporation. Paragraph (1) of section 407(a) provides that for purposes of applying this part, with respect to a qualified plan described in either section 401(a), 403(a), or 405(a), of a domestic parent corporation, an individual who is a citizen of the United States and an employee of a domestic subsidiary (as defined in paragraph (2) of section 407(a)) of a domestic parent corporation shall be treated as an employee of the domestic parent corporation if two requirements are satisfied.

The first of these requirements is that the plan of the domestic parent corporation must expressly provide coverage for U.S. citizen employees of every domestic subsidiary (as defined in paragraph (2) of section 407(a)). The second requirement is that contributions must not be provided for the employee by any other person under a funded plan of deferred compensation (whether or not such plan is a qualified plan). Contributions are not provided under a funded plan, for example, merely because the domestic subsidiary employer pays the tax imposed by section 3111 with respect to an employee.

Paragraph (2) of the new section 407(a) provides certain definitions for purposes of section 407. Paragraph (2)(A) of section 407(a) defines the term "domestic subsidiary" for purposes of section 407. Such paragraph (2)(A) sets forth three requirements which must be satisfied in order for a domestic corporation to be classified as a "domestic subsidiary." First, the domestic parent corporation must own 80 percent or more of the outstanding voting stock of the subsidiary corporation. Second, 95 percent or more of the subsidiary corporation's gross income for the 3 taxable years of such subsidiary immediately preceding the close of the taxable year of the domestic parent corporation (or for such part of such period during which the corporation was in existence) must be derived from sources without the United States. The third requirement is that 90 percent or more of the subsidiary corporation's gross income for such period (or such part) must be derived from the active conduct of a trade or business.

Paragraph (2)(B) of section 407(a) defines the term "domestic parent corporation" for purposes of section 407. A domestic parent

corporation for purposes of such section is the domestic corporation which owns 80 percent or more of the outstanding voting stock of a domestic subsidiary (as defined in paragraph (2)(A)).

(*b*) *Special rules for application of section 401(a).*—The new section 407(b) provides special rules for the application of section 401(a). The rules are substantially the same as those prescribed in the new section 406(b) (1) and (2)(A), except that the provisions of section 407(b) relate to individuals who are employees within the meaning of section 407(a), and the technical explanation of the provisions of section 406(b) (1) and (2)(A) is applicable to the provisions of section 407(b).

(*c*) *Termination of status as deemed employee not to be treated as separation from service for purposes of capital gains provisions.*—The new section 407(c) relates to certain occasions when the termination of the status as an employee within the meaning of section 407 shall not be treated as separation from service for purposes of sections 402(a)(2) and 403(a)(2) of the code. The new section 407(c) provides that an individual who is an employee of a domestic subsidiary but who is treated as an employee of a domestic parent corporation under the new section 407(a) shall not be considered as separated from the service of the domestic parent corporation solely by reason of the fact that the domestic subsidiary ceases, for any taxable year, to be a subsidiary within the meaning of section 407(a)(2)(A). Thus, for example, even though an individual who is an employee of a domestic subsidiary could not be covered under the plan of the domestic parent corporation for any taxable year in which the domestic parent corporation owned only 72 percent of the outstanding voting stock of such domestic subsidiary, such individual would not be treated as separated from service of the domestic corporation for purposes of sections 402(a)(2) and 403(a)(2) of the code.

Section 407(c) also provides that an individual shall not be treated as separated from the service by reason of the fact that—

(1) such individual ceases to be an employee of a domestic subsidiary corporation and becomes an employee of another corporation controlled by the domestic parent corporation; or

(2) the plan no longer contains the provision described in section 407(a)(1)(A).

For purposes of paragraph (1), above, a corporation is considered to be controlled by a domestic parent corporation if such domestic parent corporation owns directly or indirectly more than 50 percent of the voting stock of the corporation.

(*d*) *Deductibility of contributions.*—The new section 407(d) provides rules relating to the deductibility of contributions made on behalf of an individual who is an employee within the meaning of section 407(a). These rules are substantially the same as the rules in the new section 406(d), except that the provisions of section 407 relate to contributions on behalf of employees of domestic subsidiaries.

(*e*) *Treatment as employee under related provisions.*—The substantive provisions of the new section 407(e) are the same as the new section 406(e), except that the provisions of section 407 relate to the tax treatment of employees of domestic subsidiaries.

SECTION 221. QUALIFIED PENSION, ETC., PLAN COVERAGE FOR EMPLOYEES OF CERTAIN SUBSIDIARY EMPLOYERS—Continued

(*c*) *Technical amendments.*—Subsection (c) of section 221 of the bill sets forth certain technical amendments. Paragraph (1) of section 221(c) amends the table of sections for part I of subchapter D of chapter 1 of the Internal Revenue Code of 1954 to reflect the addition of new sections 406 and 407 of the code. Paragraph (2) of section 221(c) amends section 3121(a)(5) of the code, relating to definition of wages, to conform such definition to the provisions relating to the qualification of plans of deferred compensation which are contained in part I of subchapter D of chapter 1. Paragraph (3) of section 221(c) amends section 209(e) of the Social Security Act, relating to the definition of wages, in order to conform the provisions of this section to the provisions of section 3121(a)(5) of the code, as amended by paragraph (2) of section 221(c) of the bill.

(*d*) *Effective date.*—Subsection (d) of section 221 of the bill provides that the amendments made by subsections (a), (b), and (c)(1) of section 221 will be applicable to taxable years ending after December 31, 1963, and that the amendments made by subsections (c) (2) and (3) of section 221 shall apply to remuneration paid after December 31, 1962.

SECTION 222. EMPLOYEE STOCK OPTIONS AND PURCHASE PLANS

Section 222 of the bill (sec. 214 of the bill as passed by the House) has been approved by your committee with the amendments explained hereinafter. For the technical explanation of this section of the bill (other than the amendments made by your committee), see page A–63 of the report of the Committee on Ways and Means on the bill.

(*a*) *In general.*—Subsection (a) of this section of the bill as passed by the House has been amended by your committee as follows:

SECTION 422. QUALIFIED STOCK OPTIONS

(*a*) *Qualified stock option.*—Under the bill as passed by the House, section 422(b) of the code defined the term "qualified stock option" as an option granted to an individual after June 11, 1963 (other than a restricted stock option granted pursuant to a contract described in sec. 424(c)(4)(A) (sec. 424(c)(3)(A) of the code under the bill as amended by your committee)), for any reason connected with his employment by the corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if the requirements of paragraphs (1) through (7) of section 422(b) are met.

Your committee has amended this provision by changing the date contained therein from June 11, 1963, to December 31, 1963.

(*b*) *Special rules.*—

Certain options treated as outstanding

Under the bill as passed by the House, section 422(c)(2) of the code provided that, for purposes of section 422(b)(5) (relating to prior outstanding options)—

(A) any restricted stock option which is not terminated before January 1, 1965, and

(B) any qualified stock option granted after June 11, 1963,

shall be treated as outstanding until such option is exercised in full or expires by reason of the lapse of time. The bill as passed by the House further provided that for purposes of the preceding sentence, a restricted stock option granted before June 12, 1963, shall not be treated as outstanding for any period before the first day on which (under the terms of the option) it may be exercised.

Your committee has amended this provision by changing the dates June 11, 1963, and June 12, 1963, contained therein to December 31, 1963, and January 1, 1964, respectively.

Certain disqualifying dispositions where amount realized is less than value at exercise

Under the bill as passed by the House, section 422(c)(4) of the code provided that if an individual who has acquired a share of stock by the exercise of a qualified stock option disposes of such share within 3 years of the transfer of such share to him and if such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to the individual, then the amount includible in the gross income of such individual, and deductible from the income of his employer corporation, as compensation attributable to the exercise of such option cannot exceed the excess, if any, of the amount realized on such sale or exchange over the amount paid for such share.

Your committee has amended this provision in order to provide that the amount of compensation recognized to the individual, or deductible from the income of his employer corporation, is to be limited to the excess, if any, of the amount realized on such sale or exchange over the adjusted basis of such share. Thus, your committee's amendment changes the effect of this provision as passed by the House only if the adjusted basis of the share differs from the amount paid for the share, as might result in the case of the exercise of an option to which section 422(c)(1) (relating to exercise of option when price is less than value of stock) applies.

Exception to application of subsection (b)(5)

Under the bill as passed by the House, paragraphs (1) through (5) of section 422(c) of the code contained five special rules relating to qualified stock options. Your committee has amended section 422(c) by adding a new paragraph (6) at the end thereof. The new section 422(c)(6) (relating to exception to application of subsec. (b)(5)) provides, in effect, that a new qualified stock option being granted to an individual need not contain the limitation on exercise otherwise required by section 422(b)(5), if the new option and all the outstanding qualified (or restricted) stock options previously granted to the individual, are options to purchase stock of the same class in the same corporation, and if the price payable under each such outstanding option (determined as of the date of grant of the new qualified stock option being granted to the individual) is not more than the option price of the option being granted.

The operation of the new paragraph (6) of section 422(c) is illustrated by the following examples:

Example (1).—Assume that on January 2, 1964, A, an employee of M corporation, is granted a qualified stock option entitling him to

purchase 100 shares of M stock at a price of $5 per share (the fair market value of M stock on such date). On June 2, 1964, M grants A another qualified stock option with respect to the same class of stock as the January option, entitling him to buy 100 shares of such stock at a price of $6 per share (the fair market value of such stock on such date).

Under the bill as passed by the House, the option granted A in June must contain a provision that such option is not exercisable until the option granted in January has either been exercised in full, or has lapsed. Under the bill as amended by your committee, the June option may be exercisable before the January option since both options are to purchase the same class of stock in the same corporation and the option price of the January option ($5) is not greater than the option price of the June option ($6).

Example (2).—The facts are the same as in example (1) except that the option price of the June option is $4, the fair market value of the stock on June 2, 1964. The new rule of section 422(c)(6) (relating to exception to the application of sec. 422(b)(5)) is not applicable in this case since the price payable for the stock under the January option ($5) is greater than the option price of the June option ($4). Similarly, the exception to the application of section 422(b)(5) provided by the new section 422(c)(6) would not be applicable if the June option were granted with respect to a different class of M stock, or with respect to the stock of a parent or subsidiary of M corporation. In such a situation, the provisions of section 422(b)(5) remain applicable and the outstanding option must either be exercised in full or lapse before the more recently granted option may become exercisable.

SECTION 423. EMPLOYEE STOCK PURCHASE PLANS

(*a*) *General rule.*—Under the bill as passed by the House, section 423(a) of the code provided that the special tax treatment of the new section 421(a) shall apply to a transfer of a share of stock to an individual pursuant to his exercise of an option, if the option is granted after June 11, 1963 (other than a restricted stock option granted pursuant to a plan described in sec. 424(c)(4)(B) (sec. 424(c)(3)(B) of the code under the bill as amended by your committee)), under an employee stock purchase plan (as defined in sec. 423(b)), and if the holding period and employment requirements set forth in paragraphs (1) and (2) of section 423(a) are met.

Your committee has amended this provision by changing the date contained therein from June 11, 1963, to December 31, 1963.

SECTION 424. RESTRICTED STOCK OPTIONS

(*a*) *Restricted stock option.*—Under the bill as passed by the House, section 424(b) of the code continued the definition of the term "restricted stock option" presently contained in section 421(d)(1) for options granted before June 12, 1963 (or after June 11, 1963, if granted in accordance with sec. 424(c)(4) (sec. 424(c)(3) of the code under the bill as amended by your committee)).

Your committee has amended this provision by changing the dates contained therein from June 12, 1963, to January 1, 1964, and from June 11, 1963, to December 31, 1963.

(*b*) *Special rules.*—Under the bill as passed by the House, section 424(c) of the code provided three special rules relating to restricted stock options, all of which are identical to provisions of existing section 421, and a fourth special rule relating to certain options granted after June 11, 1963. Your committee has amended these special rules in the following respects:

Stockholder approval

Under the bill as passed by the House, the applicability of section 424(c)(2) of the code (relating to stockholder approval) was limited to restricted stock options. Your committee has extended the rule contained in section 424(c)(2) to qualified stock options and options granted under employee stock purchase plans by striking paragraph (2) of section 424(c), and by inserting a comparable provision as subsection (i) under section 425 (relating to definitions and special rules). A technical explanation of the new section 425(i) may be found, in place, below.

Certain options granted after December 31, 1963

Under the bill as passed by the House, paragraph (4) of section 424(c) of the code (sec. 424(c)(3) of the code under the bill as amended by your committee) provided the additional requirements that must be met by options granted after June 11, 1963, in order for such options to be treated as restricted stock options. In general, under the bill as passed by the House, an option granted after June 11, 1963, that otherwise meets the requirements of the new section 424(b) of the code is treated as a restricted stock option for purposes of the revised part II of subchapter D if it was granted pursuant to—

(A) a binding written contract entered into before June 12, 1963, or

(B) a written plan adopted and approved before June 12, 1963, which (as of June 12, 1963, and as of the date of the granting of the option) either met the requirements of paragraphs (4) and (5) of section 423(b) or was being administered in a way that did not discriminate in favor of officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees.

Your committee has amended this provision by changing the dates contained therein from June 11, 1963, to December 31, 1963, and from June 12, 1963, to January 1, 1964. In determining whether an option is granted pursuant to a plan described in subparagraph (B) of the provision, the terms of any written offering that was made on or before January 1, 1964, will be treated as a part of the plan.

SECTION 425. DEFINITIONS AND SPECIAL RULES

(*a*) *Modification, extension, or renewal of option.*—

Special rules for sections 423 and 424 options

Under the bill as passed by the House, subparagraph (B) of section 425(h)(2) of the code continues the rule of the existing section 421(e)(1) that provides an exception to the rule of section 425(h)(2)(A) if the average fair market value of the stock for the 12 months prior to the modification, extension, or renewal is less than 80 percent of the fair market value at the date of the original granting or any intervening

modification, extension, or renewal, whichever is higher. Under the bill as passed by the House, this exception only applies to modifications, extensions, or renewals of restricted stock options made before June 12, 1963 (or made pursuant to a binding written contract entered into before June 12, 1963).

Your committee has amended this provision by changing the date contained therein from June 12, 1963, to January 1, 1964.

Definition of modification

Under the bill as passed by the House, paragraph (3) of section 425(h) of the code defined the term "modification" in the same manner as existing section 421(e). Thus, under the bill as passed by the House, the term "modification" was defined as any change in the terms of the option which gives the employee additional benefits; but such term does not include a change in the terms of the option which is attributable to the issuance or assumption of an option under section 425(a), or to permit the option to qualify under section 422(b)(6), 423(b)(9), or 424(b)(2) if, in the case of a restricted stock option, the period during which the option may be exercised is restricted to 10 years from the date of the grant of the option.

Your committee has amended this provision by adding a new subparagraph (C) to section 425(h)(3) as set forth in the bill as passed by the House. The new subparagraph (C) added by your committee provides an additional exception to the definition of the term "modification." This new exception provides that a change in the terms of an option which is not immediately exercisable in full to accelerate the time at which the option may be exercised is not a modification for purposes of section 425(h). Thus, your committee's amendment allows an option which is exercisable only in installments, or after the expiration of a fixed period of time, or on the happening of an event, to be amended to permit acceleration of the time for exercising any (or all) of the installments, or to permit an acceleration in the time for exercising all or any portion of the option, without treating such amendment as a modification of the option.

(*b*) *Stockholder approval.*—Under the bill as passed by the House, paragraph (2) of section 424(c) of the code provided that for purposes of section 424 (relating to restricted stock options), if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. Thus, under the bill as passed by the House, the applicability of section 424(c)(2) was limited to restricted stock options.

Your committee has extended the rule of section 424(c)(2) to qualified stock options and options granted under employee stock purchase plans by striking paragraph (2) of section 424(c) as set forth in the bill as passed by the House, by redesignating section 425(i) (relating to cross references) as section 425(j) and by inserting a new section 425(i). The new section 425(i) provides that for purposes of part II of subchapter D of chapter 1 of the code (relating to certain stock options), if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval.

SECTION 222. EMPLOYEE STOCK OPTIONS AND PURCHASE PLANS—Continued

(*b*) *Administrative provisions.*—Subsection (b) of this section of the bill as passed by the House has been amended by your committee as follows:

Penalties for failure to file information returns

Subsection (b)(2) of this section of the bill as passed by the House amends section 6652(a) of the code (relating to failure to file certain information returns) to provide a penalty for the failure to file the return required by section 6039(a). Your committee has revised section 6652 as amended by the bill as passed by the House in order to make clear that the penalty provided under section 6652(a) is imposed for each failure to file the statement referred to in section 6652(a)(1), and for each failure to file a return with respect to a transfer referred to in section 6652(a)(2). Thus a penalty is incurred under section 6652(a)(2) with respect to each transfer described in the new section 6039 which the taxpayer fails to report on the return required by such section. The penalty is $10 for each such failure, not to exceed $25,000 for all failures described in section 6652(a) in any one calendar year.

Your committee has also amended section 6652(a) of the code to provide that the penalty provided by such section shall be imposed in the case of each failure to make a return required by section 6052(a) (relating to reporting payment of wages in the form of group-term life insurance) with respect to group-term life insurance on the life of an employee. (The new sec. 6052 is added to the code by sec. 204 of the bill as reported by your committee.)

(*c*) *Effective date.*—Subsection (e) of this section of the bill as passed by the House provided that the amendments made by this section apply to taxable years ending after June 11, 1963; except that the new section 6039 of the code added by subsection (b) of this section (relating to administrative provisions), and paragraph (2) of section 6652(a) of the code as amended by such subsection, apply only to stock transferred pursuant to options exercised on or after January 1, 1964.

Your committee has amended subsection (e) of this section of the bill as passed by the House by changing the general effective date of the provisions relating to employee stock options and purchase plans as passed by the House from June 11, 1963, to December 31, 1963, and by adding a special rule for certain options granted after December 31, 1963, and before January 1, 1965. The special rule is contained in a new paragraph (3) added to subsection (e) of this section of the bill as passed by the House. The new paragraph provides that paragraphs (1) and (2) of section 422(b) of the code shall not apply to an option granted after December 31, 1963, and before January 1, 1965, and that paragraph (1) of section 425(h) shall not apply to any change in the terms of such an option made before January 1, 1965, to permit the option to qualify under paragraphs (3), (4), and (5) of section 422(b).

Subparagraph (A) of the new paragraph (3) permits the transfer of a share of stock pursuant to an individual's exercise of a stock option granted after December 31, 1963, and before January 1, 1965, to

qualify for the special tax treatment provided by the revised section 421 of the code without regard to whether the option is granted pursuant to a plan, as required by section 422(b)(1), or whether the plan was approved by the shareholders. In addition, since the option need not be granted pursuant to a plan at all, the option need not be granted within 10 years from the date such plan is adopted or approved, whichever is earlier, as provided under section 422(b)(2).

Subparagraph (B) of paragraph (3) allows options granted after December 31, 1963, and before January 1, 1965, to be amended at any time before January 1, 1965, to meet the requirements of paragraphs (3), (4), and (5) of section 422(b), without such amendments being treated as a modification under section 425(h). Amendments to options under subparagraph (B) of paragraph (3) are to be retroactive to the date of grant of the option.

SECTION 223. INSTALLMENT SALES BY DEALERS IN PERSONAL PROPERTY

Section 223 of the bill, which was added by your committee to the bill as passed by the House, amends section 453(a) of the code (relating to the reporting of income by dealers in personal property from sales on the installment plan).

(*a*) *Installment plans.*—Subsection (a) of section 223 amends section 453(a) of the code by placing the existing provisions thereof in a new paragraph (1) of such subsection and by adding new paragraphs (2) and (3). The new paragraph (2) provides that for purposes of determining whether a dealer in personal property is selling such property on the installment plan so that he may return on the installment method (as described in par. (1)) the income from such sales, the term "installment plan" includes any plan which provides that the purchaser is to pay for such sales in a series of periodic installments of the debt due such dealer.

Paragraph (3) of revised section 453(a) provides that for purposes of computing the income from sales of personal property to be reported on the installment method by a dealer in personal property under paragraph (1), the term "total contract price" includes all charges relative to such sales including the time price differential which represents the amount paid or payable by the purchaser for the privilege of paying for such property in installments. Charges relative to the sale of personal property do not include charges for service contracts or warranties, or other charges for services unless such services are incidental to and rendered contemporaneously with the sale of the personal property.

(*b*) *Effective date.*—Subsection (b) of section 223 provides that the amendment made by subsection (a) of such section shall apply to taxable years beginning after December 31, 1963.

SECTION 224. TIMING OF DEDUCTIONS AND CREDITS IN CERTAIN CASES WHERE ASSERTED LIABILITIES ARE CONTESTED

Section 224 of the bill, which was added by your committee to the bill as passed by the House, amends section 461 of the 1954 Code (relating to general rule for taxable year of deduction) and section 43

of the 1939 Code (relating to period for which deductions and credits taken), and provides certain transitional rules. No provision of this section of the bill extends the period of limitations within which a claim for credit or refund may be filed for any taxable year.

(*a*) *Taxable year of deduction or credit.*—Paragraph (1) of section 224(a) of the bill, which was added by your committee to the bill as passed by the House, amends section 461 of the 1954 Code, relating to general rule for taxable year of deduction, by adding to such section a new subsection (f). In G.C.M. 25298, 1947-2 C.B. 39, the Internal Revenue Service took the position that a taxpayer may deduct the amount of taxes paid to local authorities not later than for the year of payment even though he contests liability for such taxes. In 1961, the U.S. Supreme Court held that, where an accrual basis taxpayer contested taxes paid to local authorities, the contested amount was deductible for the taxable year in which the contest was settled rather than for the taxable year in which such amount was paid (*U.S.* v. *Consolidated Edison Co.* (1961) 366 U.S. 380). The new subsection (f), in the case of contested taxes, provides that the contested amount is deductible for the year of payment.

The new subsection (f) provides in effect that if (1) a taxpayer contests an asserted liability (such as a tax assessment); (2) such taxpayer transfers money or other property to provide for the satisfaction of the asserted liability; (3) the contest with respect to the asserted liability exists after the time of the transfer; and (4) but for the fact that the asserted liability is contested, a deduction or credit would be allowed for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable), then the deduction or credit shall be allowed for the taxable year of the transfer.

The new subsection (f) is not limited to an asserted liability for taxes, but applies to any asserted liability where the requirements of the new subsection (f) are met. A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property to the person who is asserting the liability, or by a transfer to an escrow agent provided that the money or other property is beyond the control of the taxpayer. However, purchasing a bond to guarantee payment of the asserted liability, an entry on the taxpayer's books of account, or a transfer to an account which is within the control of the taxpayer is not a transfer to provide for the satisfaction of an asserted liability.

The new subsection (f) applies only if the contest with respect to the asserted liability exists after the time of payment. Thus, the new subsection (f) does not apply to Z corporation in the following example:

Example.—Z corporation uses the accrual method of accounting. In 1964 a $100 liability is asserted against Z. Z contests the asserted liability. In 1967 the contested liability is settled as being $80 which Z accrues and deducts for such year. In 1968 Z pays the $80.

If any portion of the contested amount, which is deducted in the year of payment, is refunded when the contest is settled, such portion is includible in gross income except as provided in section 111 of the 1954 Code, relating to recovery of bad debts, prior taxes, and delinquency amounts.

The new subsection (f) may be illustrated by the following examples:

Example (1).—X corporation, which uses the cash method of accounting, in 1964 contests $20 of a $100 asserted real property tax liability but pays the entire $100 to the taxing authority. In 1968, the contest is settled and X receives a refund of $5. Under the new subsection (f) of section 461 of the 1954 Code, for the taxable year 1964 X deducts $100 and for the taxable year 1968 X includes $5 in gross income (assuming sec. 111 of the 1954 Code does not apply to such amount).

Example (2).—Y corporation, which uses the accrual method of accounting, in 1964 contests $20 of a $100 asserted real property tax liability but pays the entire $100 to the taxing authority. In 1968, the contest is settled and Y receives a refund of $5. Under the new subsection (f) of section 461 of the 1954 Code, for the taxable year 1964 Y deducts $100 and for the taxable year 1968 Y includes $5 in gross income (assuming sec. 111 of the 1954 Code does not apply to such amount).

Paragraph (2) of section 224(a) of the bill, as added by your committee, amends section 43 of the 1939 Code, relating to period for which deductions and credits taken, by adding at the end of such section a new sentence. The new sentence is the same as the new subsection (f) added to section 461 of the 1954 Code by paragraph (1) of section 224(a) of the bill.

(*b*) *Effective dates*.—Subsection (b) of section 224 of the bill, as added by your committee, provides that except as provided in subsections (c) and (d) of section 224 of the bill—

(1) the new subsection (f) of section 461 of the 1954 Code, as added by paragraph (1) of section 224(a) of the bill, shall apply to transfers of money or other property in taxable years beginning after December 31, 1953, and ending after August 16, 1954, and

(2) the new sentence added to section 43 of the 1939 Code by paragraph (2) of section 224(a) of the bill shall apply to transfers of money or other property in taxable years to which the Internal Revenue Code of 1939 applies.

(*c*) *Election as to transfers in taxable years beginning before January 1, 1964*.—Paragraph (1) of section 224(c) of the bill, as added by your committee, provides that the amendments made to section 461 of the 1954 Code and section 43 of the 1939 Code by paragraphs (1) and (2), respectively, of section 224(a) of the bill shall not apply to any transfer of money or other property described in such section 224(a) made in a taxable year beginning before January 1, 1964, if the taxpayer elects, in the manner provided by regulations prescribed by the Secretary of the Treasury or his delegate, to have such paragraph (1) apply. Such an election (1) must be made within 1 year after the date of enactment of the bill, (2) may not be revoked after the expiration of such 1-year period, and (3) shall apply to all transfers of money or other property described in section 224(a) of the bill made in a taxable year beginning before January 1, 1964 (other than transfers described in par. (2) of sec. 224(c) of the bill). In the case of any transfer to which paragraph (1) of section 224(c) of the bill applies, the deduction or credit shall be allowed only for the taxable year in which the contest with respect to such transfer is settled.

Paragraph (2) of section 224(c) of the bill, as added by your committee, provides that paragraph (1) of such section 224(c) shall not

apply to any transfer if the assessment of any deficiency which would result from the application of the election in respect of such transfer is, on the date of the election under such paragraph (1), prevented by the operation of any law or rule of law.

Paragraph (3) of section 224(c) of the bill, as added by your committee, provides that if the taxpayer makes an election under paragraph (1) of section 224(c) of the bill, and if, on the date of such election, the assessment of any deficiency which results from the application of the election in respect of any transfer is not prevented by the operation of any law or rule of law, the period within which assessment of such deficiency may be made shall not expire earlier than 2 years after the date of enactment of this bill.

(*d*) *Certain other transfers in taxable years beginning before January 1, 1964.*—Subsection (d) of section 224 of the bill, as added by your committee, provides that the amendments made to section 461 of the 1954 Code and section 43 of the 1939 Code by paragraphs (1) and (2), respectively, of section 224(a) of the bill shall not apply to any transfer of money or other property described in such section 224(a) made in a taxable year beginning before January 1, 1964, if (1) no deduction or credit has been allowed in respect of such transfer for any taxable year before the taxable year in which the contest with respect to such transfer is settled, and (2) refund or credit of any overpayment which would result from the application of such amendments to such transfer is prevented by the operation of any law or rule of law. In the case of any transfer to which subsection (d) of section 224 of the bill applies, the deduction or credit shall be allowed only for the taxable year in which the contest with respect to such transfer is settled. Thus, if, at any time when a refund or credit of any overpayment, which would result from the application of the new subsection (f) of section 461 of the 1954 Code to a transfer of money or other property described in such new subsection (f) made in a taxable year beginning before January 1, 1964, is prevented by the operation of any law or rule of law, no deduction has been allowed in respect of such transfer for any taxable year before the taxable year in which the contest with respect to such transfer is settled, then a deduction shall be allowed to the taxpayer for the taxable year in which such contest is settled.

SECTION 225. INTEREST ON CERTAIN DEFERRED PAYMENTS

Section 225 of the bill (sec. 215 of the bill as passed by the House) has been approved by your committee with two modifications. For the technical explanation of this section of the bill (other than the amendments made by your committee), see the report of the Committee on Ways and Means starting at page A-84.

Your committee has deleted subsection (c) of this section of the bill as passed by the House, which related to deduction as interest of certain carrying charges on certain sales of services.

Under subsection (c) of this section (subsec. (d) of the bill as passed by the House) relating to effective dates, the amendments made by subsections (a) and (b) of section 225 apply to payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963. Your committee's amendment provides that the amendments made by subsections (a) and (b) will not

be applicable to payments made on account of a sale or exchange made pursuant to a binding written contract (including an irrevocable written option) entered into before July 1, 1963. Thus, if before such date a taxpayer has committed himself to a sale or exchange of property either by entering into a binding written sales contract or by granting an irrevocable written option entitling another person to purchase the property, any sale or exchange made pursuant to such contract or option will not be affected by the rules of new section 483.

SECTION 226. PERSONAL HOLDING COMPANIES

Section 226 of the bill (sec. 216 of the bill as passed by the House) deals with the treatment of personal holding companies and shareholders of such companies. This section of the bill as passed by the House consisted of 12 subsections, designated (a) through (l). Your committee has adopted the following subsections of this section without change: (a) relating to the personal holding company tax rate, (b) relating to the definition of a personal holding company, (e) relating to foreign personal holding company income and stock ownership, (f) relating to the dividends-paid deduction, and (h) relating to an exception for certain liquidated corporations. Your committee has rejected in its entirety subsection (j), relating to an increase in basis with respect to certain foreign personal holding company holdings, of the bill as passed by the House, has redesignated subsections (k) and (l), respectively, as subsection (j) relating to technical amendments, and subsection (k) relating to effective dates, and has made some technical amendments in redesignated subsection (k) to reflect this elimination.

The changes made by your committee in remaining subsections (c), (d), (g), and (i) of this section are discussed below. For the technical explanation of this section (other than the amendments made by your committee), see page A–88 of the report on the bill by the Committee on Ways and Means.

Section 226(c), relating to excluded corporations

Subsection (c) of section 226 of the bill has been approved by your committee with four modifications. For the technical explanation of subsection (c) of the bill (except for the amendments explained below), see page A–89 of the report on the bill by the Committee on Ways and Means.

Under the bill as passed by the House, a lending or finance company is excluded from the definition of a personal holding company if it meets four requirements: (1) At least 60 percent of its ordinary gross income must be derived directly from the active and regular conduct of a lending or finance business; (2) its personal holding company income (computed (a) without regard to income qualifying under the 60-percent test, (b) by including as personal holding company income the entire amount of the gross income from rents, royalties, produced film rents, and compensation for the use of corporate property by shareholders, and (c) without regard to certain income from domestic subsidiaries described in sec. 542(d)(3) of the code), plus the interest described in section 543(b)(2)(C) of the code, must not exceed 20 percent of ordinary gross income; (3) business deductions directly allocable to the active and regular conduct of its lending or finance business must equal or exceed the sum of (i) 15

percent of its ordinary gross income up to $500,000, plus (ii) 5 percent of its ordinary gross income between $500,000 and $1,000,000; and (4) loans to substantial shareholders must not exceed $5,000 in principal amount.

In applying the 20-percent-of-ordinary-gross-income test of section 542(c)(6)(B), your committee has deleted the provision that interest described in section 543(b)(2)(C) be included with the corporation's personal holding company income. This change conforms the treatment of such interest under section 542(c)(6)(B) to the treatment thereof for all other personal holding company tax purposes.

Under the bill as passed by the House, section 542(d)(3) of the code provides that the lawful income received by a lending company which is in the small loan business (consumer finance business) from domestic subsidiary corporations which are themselves excepted from the definition of a personal holding company under section 542(c)(6), is not included for purposes of the 20-percent-of-ordinary-gross-income test of section 542(c)(6)(B). Your committee has amended this provision in two respects. First, the corporation receiving such income may be any lending or finance company which meets the 60-percent requirement of section 542(c)(6)(A). It does not have to meet the more restrictive requirement of being in the small loan (consumer finance) business. Second, the payor corporation may be any member of the same affiliated group (as defined in sec. 1504) as the corporation receiving such income. Thus the corporation receiving such income is not required to be the parent corporation of the payor corporation. The payor corporation must still meet the requirements of section 542(c)(6).

Under the bill as passed by the House, section 542(d)(1)(A) of the code defines a lending or finance business, generally, as a business of making loans, or purchasing or discounting accounts receivable, notes, or installment obligations.

Your committee has amended the definition of a lending or finance business in section 542(d)(1) to include therein the business of rendering services or making facilities available to another member of the same affiliated group (as defined in sec. 1504) that is also in the lending or finance business.

Under the 60-percent-of-ordinary-gross-income test provided in section 542(c)(6)(A) of the code the corporation's income must be derived "directly" from the active and regular conduct of a lending or finance business. In addition, a reference to this provision is made in section 542(c)(6)(B). The use of the term "directly" is intended to emphasize that the 60-percent test is limited to income "derived from the active and regular conduct" of a lending or finance business, and excludes income that is unrelated to the conduct of the lending or finance business itself. Thus, for example, under section 542(c)(6)(A) as approved by your committee, interest income earned by the lending or finance company from loans to customers would qualify under the 60-percent test, but interest earned from the investment of its idle funds in short-term securities would not qualify under the 60-percent test.

The phrase "directly allocable to the active and regular conduct of its lending or finance business" is used in section 542(c)(6)(C) (business expense test) and, with a minor difference in language, in section 542(d)(2)(B) (relating to deductions for depreciation and real property

taxes). As used in these provisions, the term "directly" is intended to exclude expenses unrelated to the conduct of the finance or lending business. It is not intended to exclude completely deductions allocable only in part to such business. Thus, for example, to the extent that general overhead expenses of a corporation are properly allocable to the lending and finance business, they qualify as business deductions under section 542(d)(2).

Section 226(d), relating to personal holding company income

Subsection (d) of section 226 of the bill amends section 543(a) of the code (relating to personal holding company income). It also amends section 543(b) to provide definitions of the new terms "ordinary gross income," "adjusted ordinary gross income," "adjusted income from rents," and "adjusted income from mineral, oil, and gas royalties."

The amended section 543(a) provides that for purposes of subtitle A, the term "personal holding company income" means the portion of the adjusted ordinary gross income (as defined in sec. 543(b)(2)) which consists of the items described in paragraphs (1) through (8) of such section.

Your committee has approved subsection (d) of section 226 of the bill except for changes in paragraph (2) of section 543(a) as amended (relating to rents), in subparagraph (A) of section 543(b)(2) as amended (relating to required adjustments in the amount of gross income from rents includible in adjusted ordinary gross income), and in paragraph (4) of section 543(b) as amended (defining "adjusted income from mineral, oil, and gas royalties").

Rents

Section 543(a)(7) of existing law provides that rents are personal holding company income unless such rents constitute 50 percent or more of gross income.

The bill as passed by the House provides in paragraph (2) of section 543(a) as amended, which corresponds to the existing section 543(a)(7), that only so much of the gross income from rents as is equal to the adjusted income from rents (as defined in sec. 543(b)(3)) is personal holding company income and that the adjusted income from rents shall not be treated as personal holding company income if (A) it constitutes 50 percent or more of the corporation's adjusted ordinary gross income (as defined in sec. 543(b)(2)), and (B) the corporation's personal holding company income for the taxable year, computed without regard to such rents and compensation for the use of the corporation's property by its shareholders, and computed by treating copyright royalties and adjusted income from mineral, oil, and gas royalties as personal holding company income, is not more than 10 percent of the ordinary gross income as defined in section 543(b)(1). Thus, under the bill as passed by the House, even though adjusted income from rents constitutes more than 50 percent of a corporation's adjusted ordinary gross income, this income will still be treated as personal holding company income if the corporation's other income which is classified as personal holding company income exceeds 10 percent of its total ordinary gross income. For examples and the technical explanation of these tests in the bill (except for the amendment made by your committee), see page A-93 of the report on the bill by the Committee on Ways and Means.

Your committee has modified the 10-percent test in subparagraph (B) of section 543(a)(2) in the bill passed by the House to provide that adjusted income from rents which meets the 50-percent requirement of subparagraph (A) thereof shall not be treated as personal holding company income if the sum of the consent dividends (determinded under sec. 565) and the dividends paid or considered as paid (determined under secs. 562 and 563) during the taxable year by the corporation to its shareholders equals or exceeds the amount, if any, by which the corporation's personal holding company income for the taxable year, computed without regard to such rents and compensation for the use of the corporation's property by its shareholders, and computed by treating copyright royalties and adjusted income from mineral, oil, and gas royalties as personal holding company income, exceeds 10 percent of the ordinary gross income as defined in section 543(b)(1).

The effect of this modification in the 10-percent test applicable to rents is that this test shall be deemed to be met if the corporation pays dividends to its shareholders in an amount which is at least equal to its other personal holding company income which is in excess of 10 percent of total ordinary gross income. The difference in this test in the bill as passed by the House and as modified by your committee may be illustrated by the following example:

Example.—Corporation F receives $40 in dividends and $150 of gross income from rents. Corporation F also realizes $10 in capital gain on the sale of securities. Corporation F's deductions for depreciation, interest, and real property taxes allocable to the rents equal $100. Under existing law the rents are not personal holding company income and corporation F is not a personal holding company, since its gross income from rents ($150) constitutes 50 percent or more of its gross income ($200). Under the 50-percent requirement of the new provisions, the adjusted income from rents, $50 ($150 less $100), is 55.5 percent of adjusted ordinary gross income of $90 ($200 less the sum of $100 of adjustments and $10 of capital gains). Accordingly the adjusted income from rents meets the new 50-percent requirement. However, other personal holding company income (the dividend income of $40) is $21 in excess of the allowable 10 percent of ordinary gross income ($190: $200 less $10). Under the bill as passed by the House, the adjusted income from rents is personal holding company income and, therefore, all of corporation F's adjusted ordinary gross income is personal holding company income. However, with the modification in the 10-percent test made by your committee, the adjusted income from rents would not be treated as personal holding company income if corporation F pays a dividend of $21 to its shareholders during the taxable year. On the other hand, if the amount of the dividend paid by corporation F is less than $21, the adjusted income from rents would be personal holding company income as under the bill as passed by the House.

Adjustments to rents included in adjusted ordinary gross income

The bill as passed by the House defines in paragraph (2) of section 543(b) of the code, as amended, the term "adjusted ordinary gross income" as the ordinary gross income adjusted as provided in subparagraphs (A), (B), and (C) of such paragraph. Adjusted ordinary gross income as so defined replaces the concept of gross income of

existing law as the denominator in the fraction used in computing certain percentages involved in determining a corporation's status as a personal holding company. With one exception relating to the adjustments required for gross income from rents, your committee has approved proposed section 543(b)(2). For the technical explanation of these provisions of the bill (except the amendment explained below), see page A-100 of the report on the bill by the Committee on Ways and Means.

Subparagraph (A) of section 543(b)(2) provides that from the gross income from rents (as defined in the second sentence of sec. 543(b)(3)) there is to be subtracted the amounts allowable as deductions for exhaustion, wear and tear, obsolescence, and amortization as well as deductions for property taxes, interest, and rent to the extent that such deductions are allocable, under regulations prescribed by the Secretary of the Treasury or his delegate, to the gross income from rents. In no case may the amounts subtracted under subparagraph (A) exceed the gross income from rents.

Your committee has amended subparagraph (A)(i) of section 543(b)(2) to provide that the gross income from rents derived from leases of tangible personal property which is not customarily retained by any one lessee for a period of more than 3 years shall not be reduced by allowable deductions for exhaustion, wear and tear, obsolescence, and amortization of such property. It is the period of customary retention or use by lessees, rather than the term of the lease of the property in any one case, which is determinative of whether the adjustment shall be required.

Adjusted income from mineral, oil, and gas royalties

The bill as passed by the House provides in paragraph (3) of section 543(a) of the code as amended, which corresponds to section 543(a)(8) of existing law, tests for determining whether the "adjusted income from mineral, oil, and gas royalties", as defined in paragraph (4) of section 543(b), is personal holding company income. For the technical explanation of these provisions (except the amendment explained below), see page A-95 of the report on the bill by the Committee on Ways and Means. These provisions have been approved by your committee but an amendment has been added to section 543(b)(4) to specifically include production payments and overriding royalties as mineral, oil, and gas royalties for purposes of classification as personal holding company income under section 543(a).

The Treasury regulations interpreting section 543(a)(8) of existing law currently define the term "mineral, oil, or gas royalties" as including production payments and overriding royalties. (See Reg. § 1.543-1(b)(11)(ii).) However, it has been brought to the attention of your committee that this interpretation of existing section 543(a)(8) is disputed by some taxpayers. Your committee's amendment would make it clear that production payments and overriding royalties are to be treated as mineral, oil, and gas royalties under proposed section 543(b)(4). This amendment is not intended to affect any case involving interpretations of section 543(a)(8) of existing law.

Section 226(g), relating to 1-month liquidations

Subsection (g) of section 226 of the bill adds a new subsection (g) to section 333 of the code. The existing section 333 provides that in certain corporate liquidations gain is recognized to qualified electing

shareholders only to the extent of earnings and profits accumulated by the corporation after February 28, 1913, and cash, stock, and securities acquired by the corporation after December 31, 1953, and, with respect to accumulated earnings and profits, is taxable as a dividend to noncorporate shareholders.

Subsection 333(g) as added by the bill as passed by the House consists of three paragraphs. Paragraph (1) provides that if a corporation which is referred to in paragraph (3) of the new subsection is liquidated before January 1, 1966, no gain will be recognized to a qualifying electing shareholder with respect to the distribution of stock and securities acquired by the liquidating corporation before January 1, 1963, and gain realized by a noncorporate shareholder with respect to the corporation's accumulated earnings and profits generally is to be treated as "class B capital gain" rather than as a dividend. Paragraph (2) of subsection (g) provides special rules for liquidations after December 31, 1965, of corporations referred to in paragraph (3) of the new subsection which owe qualified indebtedness (as defined in sec. 545(c)(3)) on August 1, 1963. Paragraph (3) of subsection (g) describes the corporations to which paragraphs (1) and (2) of section 333(g) may apply. Such a corporation in the bill as passed by the House is one which was not a personal holding company under section 542 of existing law for at least one of its two most recent taxable years ending before the date of enactment of section 333(g), but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such preceding taxable year.

Your committee has approved in substance the provisions of paragraphs (1), (2), and (3) of section 333(g) as added by the bill as passed by the House but has modified some of the applicable dates therein and has added a new paragraph (4) to new section 333(g) of the code. These modifications and new paragraph (4) of section 333(g) are discussed below. For the technical explanation of section 226(g) of the bill (except for the amendments made by your committee), see page A-107 of the report on the bill by the Committee on Ways and Means.

Your committee has amended paragraph (1) of section 333(g) to provide that it shall be applicable to corporate liquidations occurring before January 1, 1967 (instead of January 1, 1966) and has amended paragraph (2) of section 333(g) to provide that it shall be applicable to liquidations occurring after December 31, 1966 (instead of Dec. 31, 1965) of corporations which owe qualified indebtedness (as defined in sec. 545(c)) on January 1, 1964 (instead of Aug. 1, 1963). Your committee has made conforming amendments in these two paragraphs of section 333(g) to reflect these changes and also changes made in other parts of the bill as approved by your committee.

Your committee has amended paragraph (3) of section 333(g), which describes the corporations to which paragraphs (1) and (2) of the new subsection may apply, to provide that such a corporation is one which was not a personal holding company under section 542 of existing law for at least one of its two most recent taxable years ending before December 31, 1963 (instead of the date of enactment of new subsec. (g)) but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first

taxable year beginning after December 31, 1963, had been applicable to such preceding taxable year.

Your committee has added a new paragraph (4) to subsection (g) of section 333 which provides that if an election is made under such section by a qualified electing shareholder (as defined in sec. 333(c)) of a corporation and the shareholder states in such election that it is made on the assumption that the corporation is a corporation referred to in paragraph (3) of subsection (g), the election under section 333 shall have no force or effect if it is determined that the corporation is not a corporation referred to in section 333(g)(3). A qualified electing shareholder who does not include such a statement in an election made and filed under section 333 will be considered to have made an election under the general rule of subsection (a) of such section with respect to recognition of gain on the shares owned by him in the liquidating corporation in the event that the special rule of subsection (g) is inapplicable because the corporation is not a corporation referred to in paragraph (3) thereof.

Section 226(i), relating to deduction for amortization of indebtedness

Subsection (i) of section 226 of the bill adds a new subsection (c) to section 545 of the code which provides a new deduction from taxable income for purposes of determining undistributed personal holding company income (as defined in sec. 545(a)).

Section 545(c) of the code as added by subsection (i) consists of six paragraphs. Paragraph (1) of the new section 545(c) provides the general rule that, except as otherwise provided in such section, there shall be allowed as a deduction (in computing undistributed personal holding company income) amounts used, or amounts irrevocably set aside (to the extent reasonable with reference to the size and terms of the indebtedness), to pay or retire qualified indebtedness (as defined in sec. 545(c)(3)). Paragraph (2) describes the corporations which may qualify for the deduction provided in paragraph (1) of section 545(c). Paragraph (3) defines the term "qualified indebtedness," subject to certain exceptions, as the outstanding indebtedness incurred by the taxpayer after December 31, 1933, and before August 1, 1963, and the outstanding indebtedness (if not otherwise deducted) incurred after July 31, 1963, for the purpose of making a payment or set-aside referred to in section 545(c)(1) in the same taxable year. Paragraph (4) provides that a corporation may elect to treat as nondeductible an amount otherwise deductible under paragraph (1) of section 545(c). Paragraph (5) provides certain limitations on the amount of the deduction otherwise allowed by section 545(c)(1). Paragraph (6) provides that the total amounts of the taxpayer's qualified indebtedness (as defined in sec. 545(c)(3)(A)) are reduced if property (of a character which is subject to the allowance for exhaustion, wear and tear, obsolescence, or amortization) is disposed of after July 31, 1963.

Your committee has approved in substance the provisions of subsection (i) of the bill as passed by the House. For the technical explanation of subsection (i) of the bill, other than the amendments explained below, see page A-113 of the report on the bill by the Committee on Ways and Means. However, your committee has amended paragraph (3) of proposed section 545(c) to provide that the term "qualified indebtedness" shall include the outstanding indebtedness incurred by the taxpayer before January 1, 1964, and has made conforming amendments in the other paragraphs of section 545(c).

Your committee has also amended paragraphs (5) and (6) of section 545(c) to provide that allowable deductions for depletion shall be taken into account to reduce the deduction allowed by section 545(c) and qualified indebtedness under certain circumstances. Your committee has also amended paragraph (2)(A) of section 545(c), which describes a category of corporations to which paragraph (1) of the new subsection may apply, to provide that such a corporation is one which was not a personal holding company under section 542 of existing law for at least one of its two most recent taxable years ending before December 31, 1963 (instead of the date of enactment of this subsection) but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such preceding taxable year.

SECTION 227. TREATMENT OF PROPERTY IN CASE OF OIL AND GAS WELLS

Section 227 of the bill (sec. 217 of the bill as passed by the House) has been approved by your committee without change. For the technical explanation of this section of the bill, see page A-122 of the report of the Committee on Ways and Means on the bill.

SECTION 228. TREATMENT OF CERTAIN IRON ORE ROYALTIES

(*a*) *In general.*—Subsection (a) of section 228 of the bill (sec. 218 of the bill as passed by the House) has been approved by your committee except that your committee has (1) restricted its application to iron ore mined in the United States, and (2) provided that the treatment provided by the bill shall not apply to any disposal of iron ore to certain related persons. For the technical explanation of section 228(a) of the bill (other than the amendments made by your committee), see page A133 of the report of the Committee on Ways and Means on the bill.

Under your committee's amendments two types of dispositions of iron ore to related persons will not qualify for treatment under section 631(c) of the code. The first type of such disposition occurs in any disposal to a person whose relationship to the party disposing of such iron ore is such that a loss would be disallowed under section 267 (relating to losses, etc., with respect to transactions between related taxpayers) or section 707(b) (relating to certain sales or exchanges of property with respect to controlled partnerships). Thus, iron ore royalty payments made under a lease between a father and his son would not qualify for treatment under section 631(c). The second type of such disposition occurs in any disposal to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such iron ore. The test for determining the presence or absence of control is the same test as is presently applied in section 482 of the code (relating to the allocation of income and deductions between taxpayers).

(*b*) *Clerical amendments.*—Subsection (b) of section 228 of the bill contains the various clerical and conforming amendments to the code and to the Social Security Act which are required as a result of the amendments made by subsection (a) of such section.

(c) *Effective date.*—Subsection (c) of this section as passed by the House provided that the amendments made by such section shall apply to iron ore mined in taxable years beginning after December 31, 1963. Your committee has amended this subsection to provide that such amendments shall apply to amounts received or accrued in taxable years beginning after December 31, 1963, attributable to iron ore mined in such taxable years.

SECTION 229. INSURANCE COMPANIES

Section 229 of the bill, which is a new section added to the bill as passed by the House, contains amendments to subchapter L of chapter 1 of the code (relating to insurance companies).

(a) *Certain mutualization distributions made in 1962.*—Subsection (a) of section 229 of the bill relates to stock life insurance companies which adopted a plan of mutualization before January 1, 1958.

Allowance of deduction

Paragraph (1) of section 229(a) of the bill amends section 809(d)(11) of the code (relating to certain mutualization distributions) to allow as a deduction in the computation of gain from operations, distributions made in 1962 to shareholders, in acquisition of stock, pursuant to a plan of mutualizaton adopted by the company before January 1, 1958.

Thus, your committee's amendment allows life insurance companies which adopted a plan of mutualization before January 1, 1958, an additional year (1962) to complete their plan of mutualization by acquiring their stock out of annual earnings, and to receive a deduction for amounts paid for that purpose. The amount deductible is limited to amounts actually paid to shareholders in 1962, and does not include accruals paid in subsequent years. In addition, the deduction allowed by the revised section 809(d)(11) is subject to the limitations of section 809(g) of the code (relating to limitations on deductions for certain mutualization distributions).

Application of section 815

Paragraph (2) of section 229(a) of the bill amends section 809(g)(3) of the code (relating to application of sec. 815) to extend the special rules of section 815(e) to include mutualization distributions deductible under the revised section 809(d)(11).

(b) *Accrual of bond discount.*—Subsection (b) of section 229 of the bill relates to the accrual of bond discount by insurance companies subject to tax under parts I and II of subchapter L of chapter 1 of the code (relating to life insurance companies, and mutual insurace companies (other than life, marine, and certain fire or flood insurance companies) etc., respectively).

Life insurance companies

Paragraph (1) of section 229(b) of the bill amends section 818(b) of the code (relating to amortization of premium and accrual of discount) by adding a new paragraph (3) at the end thereof. The new section 818(b)(3) provides that for taxable years beginning after December 31, 1962, no accrual of discount shall be required under section 818(b)(1) on any bond (as defined in section 171(d)) except as otherwise provided under subparagraphs (A) and (B) of section 818(b)(3).

Subparagraph (A) of the new section 818(b)(3) relates solely to discount on tax-exempt obligations and provides that discount which is interest described in section 103 (relating to interest on certain governmental obligations) must still be accrued. Thus, your committee's amendment makes no change in existing law with respect to issue discount (the difference between issue price and the stated redemption price at maturity) on tax-exempt obligations. Such discount must still be accrued under section 818(b)(1) of the code. On the other hand, your committee's amendment changes existing law with respect to discount on tax-exempt obligations which is not "issue discount." The accrual of such discount will no longer be required.

Subparagraph (B) of the new section 818(b)(3) relates solely to bonds which are not tax-exempt obligations within the meaning of section 103, and provides that orginal issue discount (as defined in sec. 1232(b)) must be accrued under section 818(b)(1).

Under existing law, section 818(b)(1) requires life insurance companies to accrue all discount, regardless of whether it is "issue discount," original issue discount, or "market discount." The new paragraph (3) of section 818(b) of the code changes existing law only with respect to "market discount." Such discount is no longer required to be accrued. Thus, the recognition of gain attributable to market discount is postponed until the disposition of the bond. Upon the disposition of the bond, gain attributable to market discount will ordinarily be taxable as capital gain. The adjustment to basis for the accrual of market discount will no longer be allowed to the extent such discount is not accrued by reason of the new section 818(b)(3).

The new section 818(b)(3) also provides that for purposes of section 805(b)(3)(A), the current earnings rate for any taxable year beginning before January 1, 1963, shall be determined as if the first sentence of the new section 818(b)(3) applied to such taxable year.

Mutual insurance companies

Paragraph (2) of section 229(b) of the bill amends section 822(d)(2) of the code (relating to amortization of premium and accrual of discount) by adding a new sentence at the end thereof. This sentence provides that for taxable years beginning after December 31, 1962, no accrual of discount shall be required under section 822(d)(2) of the code on any bond (as defined in sec. 171(d)). Under the new sentence neither "issue discount," original issue discount, nor "market discount," is required to be accrued under section 822(d)(2). This provision has the effect of postponing until disposition of the bond any recognition of income attributable to bond discount, at which time the provisions of section 1232 may be applicable. No adjustment in the basis of any bond attributable to discount shall be permitted for taxable years beginning after December 31, 1962, to the extent such discount is not accrued by reason of the amended section 822(d)(2).

For taxable years beginning after December 31, 1962, no discount shall be required to be accrued pursuant to section 282(d)(2) regardless of when the bond to which the discount is attributable was acquired.

(c) *Contributions to qualified, etc., plans.*—Subsection (c) of section 229 of the bill amends section 832(c)(10) of the code (relating to deductions allowed in computing taxable income of insurance com-

panies (other than life or mutual), mutual marine insurance companies, and certain mutual fire or flood insurance companies) by adding a new phrase at the end thereof. The new phrase provides that, in computing the taxable income of insurance companies subject to the tax imposed by section 831, there shall be allowed the deduction provided in part I of subchapter D of chapter 1 of the code (sec. 401 and following, relating to pension, profit-sharing, stock bonus plans, etc.). In allowing these companies to deduct their contributions to an employees' trust or annuity plan and compensation under a deferred-payment plan under section 404 of the code, subsection (c) of section 229 of the bill is in accord with existing administrative practice.

(*d*) *Effective dates.*—Subsection (d) of section 229 of the bill provides that the amendment made by subsection (a) of the bill (relating to certain mutualization distributions made in 1962) shall apply to taxable years beginning after December 31, 1961, and that the amendment made by subsection (c) of the bill (relating to contributions to qualified, etc., plans) shall apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954. No provision of this section extends the period of limitations within which a claim for credit or refund may be filed for any taxable year.

SECTION 230. REGULATED INVESTMENT COMPANIES

Section 230 of the bill, which is a new section added to the bill as passed by the House, relates to regulated investment companies.

(*a*) *Time for mailing certain notices to shareholders.*—Subsection (a) of section 230 of the bill amends several provisions of part I, subchapter M, chapter 1 of the code (relating to regulated investment companies) by increasing from 30 days to 45 days after the close of a taxable year the time within which a regulated investment company must give certain notices to its shareholders.

Under section 852(b)(3)(C) of existing law, a capital gain dividend is defined, in general, as any dividend, or part thereof, which is designated by the company as a capital gain dividend in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year. Under the bill, a 45-day period is substituted for the 30-day period.

Under section 852(b)(3)(D)(i) of existing law, a shareholder of a regulated investment company, in computing his long-term capital gains for his taxable year in which the last day of the regulated investment company's taxable year falls, must include such amount as the company designates as his share of undistributed capital gains in a written notice mailed to its shareholders at any time prior to the expiration of 30 days after the close of the regulated investment company's taxable year. Under the bill, the 30-day period is changed to a 45-day period.

Section 853 of existing law provides that, if certain conditions are met, a regulated investment company may elect to treat as having been distributed to its shareholders any income, war profits, and excess profits taxes paid by it to any foreign country or to any possession of the United States. The shareholders of the company must include the amount of such taxes in gross income and must treat such amount as paid by them for purposes of the deduction under section

164(a) and the foreign tax credit under section 901. Under section 853(c), the amounts to be so treated by the shareholders may not exceed the amounts so designated by the company in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year. The bill changes the 30-day period to a 45-day period.

Section 854(b)(1) of existing law provides limitations to be applied in determining the extent to which any dividend (other than a capital gain dividend) may be taken into account by a shareholder of a regulated investment company for purposes of the credit under section 34, the exclusion under section 116, and the deduction under section 243. Section 854(b)(2) provides that the amount of any distribution which may be taken into account as a dividend for such purposes may not exceed the amount so designated by the regulated investment company in a written notice to its shareholders mailed not later than 30 days after the close of its taxable year. The bill changes the 30-day period to a 45-day period.

Section 855 provides that, if certain conditions are met, a dividend which is paid by a regulated investment company, after the close of a taxable year, may be considered by the company as having been paid during such taxable year. Section 855(c) provides that any notice to shareholders required under part I of subchapter M with respect to such a dividend must be mailed not later than 30 days after the close of the taxable year in which the distribution of such dividend is made. The bill changes the 30-day period to a 45-day period.

(*b*) *Certain redemptions by unit investment trusts.*—Subsection (b) of section 230 of the bill amends section 852 of the code (relating to taxation of regulated investment companies and their shareholders) by adding a new subsection (d) at the end thereof.

Under section 852(b) of existing law, a regulated investment company is allowed a deduction for dividends paid (as defined in sec. 561), other than capital gains dividends, in determining its investment company taxable income, and is allowed a deduction for dividends paid (as defined in sec. 561), determined with reference to capital gains dividends only, in computing that part of the excess of its net long-term capital gain over net short-term capital loss on which it must pay a capital gains tax. Section 561(b) provides that in determining the deduction for dividends paid, the rules provided in section 562 are applicable. Section 562(c) (relating to preferential dividends) provides that the amount of any distribution shall not be considered as a dividend unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled to such preference.

New subsection (d) of section 852 provides that in the case of a unit investment trust—

(1) which is registered under the Investment Company Act of 1940 and issues periodic payment plan certificates (as defined in such act), and

(2) substantially all of the assets of which consist of securities issued by a management company (as defined in such act)—

section 562(c) shall not apply to a distribution by such trust to a holder of an interest in such trust in redemption of part or all of such interest, with respect to the net capital gain of the trust attributable to such redemption. Thus, assume that a holder of an interest in

such a trust requests that part or all of such interest be redeemed. In order to obtain the amount of cash required to redeem such interest, the trust liquidates part of its portfolio, represented by shares in a management company, and realizes a long-term capital gain on such liquidation. That amount of the cash distributed to the redeeming interest holder which represents a distribution of such realized long-term capital gain is considered to be a distribution by the trust which qualifies for the deduction for dividends paid with reference to capital gains dividends under section 852(b)(3)(A).

(c) *Effective dates.*—Subsection (c) of section 230 of the bill provides that the amendments made by subsection (a) shall apply to taxable years of regulated investment companies ending on or after the date of the enactment of the bill, and that the amendment made by subsection (b) shall apply to taxable years of regulated investment companies ending after December 31, 1963.

SECTION 231. FOREIGN TAX CREDIT WITH RESPECT TO CERTAIN FOREIGN MINERAL INCOME

Section 231 of the bill, which is a new section added to the bill as passed by the House, amends section 901 (relating to credit for foreign taxes) by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) a new subsection (d) relating to foreign taxes on mineral income.

(a) *Foreign taxes on mineral income.*—Paragraph (1) of new subsection (d) provides that in certain cases the amount of foreign taxes described in section 901(b) (relating to amount of foreign tax allowed as a credit) which are paid or accrued during the taxable year with respect to mineral income to any foreign country (if the per-country limitation applies), or to all foreign countries (if the overall limitation applies), is to be reduced for purposes of computing the foreign tax credit. The reduction, if any, is equal to the amount by which the U.S. tax computed under chapter 1 of the code with respect to the same mineral income and computed before the allowance of any tax credit (such tax hereinafter referred to as the "U.S. tax") is exceeded by the lesser of the following two amounts: (1) The amount of such foreign taxes paid or accrued with respect to such income, or (2) the U.S. tax with respect to such income computed without the deduction for percentage depletion under section 613 but with the deduction for cost depletion determined with reference to the basis for cost depletion under section 612. The computation described in item (2) is made only to determine the amount of foreign taxes to be taken into account in computing the foreign tax credit and does not affect the manner in which a taxpayer actually computes the allowance for depletion under chapter 1 in determining the U.S. tax. In no case will the foreign tax on mineral income under new subsection (d) be reduced to an amount which is less than the U.S. tax on such mineral income. The credit for taxes paid or accrued to possessions of the United States is not affected by this provision.

Paragraph (2) of the new subsection (d) defines the term "mineral income" for purposes of subsection (d). The term means income derived from sources without the United States from mineral activities including dividends received from corporations in which 5 percent or more of the voting stock is owned directly or indirectly by the tax-

payer, to the extent such dividends are attributable to mineral activities, and that portion of the taxpayer's distributive share of partnership income attributable to mineral activities. For such purpose the term "mineral activities" includes the extraction of minerals from mines, wells, or other natural deposits, the processing of such minerals into their primary products, and the transportation, distribution, or sale of such minerals or primary products. For example, in the case of oil, mineral activities of a taxpayer would include the extraction of the crude oil from the ground, transportation of the crude oil by pipeline or ship to a refinery, refining of the crude oil to obtain gasoline and other products resulting from such refining, and the sale of such products. However, the manufacture of chemical products from oil would not be considered the processing of oil into its primary products, and thus would not be considered a mineral activity. Similarly, the transportation, distribution, or sale of the chemical products would not be considered a mineral activity. If primary products of oil, such as gasoline, are sold through outlets of the taxpayer which also sell other products, only the sale of the primary products would be a mineral activity.

(*b*) *Effective date.*—The amendments made by section 231 of the bill are applicable to taxable years beginning after December 31, 1963.

SECTION 232. AMOUNTS RECEIVED FROM EMPLOYER ON SALE OF RESIDENCE OF EMPLOYEE IN CONNECTION WITH TRANSFER TO NEW PLACE OF WORK

(*a*) *Treatment of certain amounts received from employer on sale of residence of employee in connection with transfer to new place of work.*—Subsection (a)(1) of section 232 of the bill, which is a new section added to the bill as passed by the House, adds a new section 1003 to part I of subchapter O of chapter 1 of the code (relating to determination of amount of and recognition of gain or loss).

It has been held that an amount received by an employee from his employer, in respect of the sale of the employee's residence in connection with his transfer to a new place of work, is taxable as compensation. (*Harris W. Bradley*, 39 T.C. 652 (1963), aff'd 324 F. 2d 610 (4th Cir. 1963); *Arthur J. Kobacker*, 37 T.C. 882 (1962).)

SECTION 1003. AMOUNTS RECEIVED FROM EMPLOYER ON SALE OF RESIDENCE OF EMPLOYEE IN CONNECTION WITH TRANSFER TO NEW PLACE OF WORK

(*a*) *General rule.*—Subsection (a) of new section 1003 provides the general rule that if, in connection with the transfer of the taxpayer as as an employee to a new place of work, the taxpayer or his spouse sells property used as his principal residence "old residence" pursuant to a sales contract entered into within the forced sale period, and within 1 year after the date of such contract his employer pays part or all of the "sale differential," then the amount so paid shall be treated by the taxpayer or his spouse as an additional amount realized on the sale of the old residence to the extent that it does not exceed the lesser of (A) the "sale differential," or (B) 15 percent of the gross sales price of the old residence.

Section 1003 is applicable only with respect to the sale of a taxpayer's principal residence. Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each individual case. Property which qualifies as a principal residence for purposes of section 1034 will be considered a principal residence for purposes of section 1003.

Where property is used by the taxpayer partially as his principa residence and partially for business purposes or in the production of income (as in the case where a part of the building in which the taxpayer resides is used as an office or is rented), then only that portion of the reimbursement, appraised value, gross sales price, and selling expenses attributable to that part of the property used as the taxpayer's principal residence shall be considered for purposes of section 1003.

The gross sales price of the old residence is the total consideration received upon the sale by the taxpayer, and includes the amount of any mortgage, trust deed, or other indebtedness to which the property is subject in the hands of the purchaser whether or not the purchaser assumes such indebtedness. It also includes the face amount of any liabilities of the purchaser which are part of the consideration for the sale. Commissions, and other selling or fixing up expenses paid or incurred by the taxpayer in connection with the sale of the old residence, are not to be deducted or taken into account in determining the gross sales price of the old residence.

(b) *Limitations.*—Subsection (b) of new section 1003 provides certain limitations on the applicability of section 1003.

Period of employment

Paragraph (1) of subsection (b) limits the application of section 1003 to those cases where the taxpayer was employed for the 6-month period ending on the day on which he commences work at the new principal place of work by the employer who makes the reimbursement.

Location of new place of work

Paragraph (2) of subsection (b) provides that section 1003 shall not apply unless the distance between the taxpayer's new principal place of work and his old residence exceeds by at least 20 miles the distance between the taxpayer's former principal place of work and his old residence. If the taxpayer, prior to his transfer, had no principal place of work, section 1003 shall not apply unless the distance between his new principal place of work and his old residence is at least 20 miles. For purposes of measuring distances under section 1003(b)(2), all computations are to be made on the basis of a straight-line measurement.

(c) *Definitions; special rules.*—Subsection (c) of new section 1003 provides definitions and special rules for the application of section 1003.

Forced sale period

The term "forced sale period," as defined in paragraph (1) of subsection (c), is the period which begins 90 days before, and ends 180 days after, the date on which the taxpayer commences work as an employee at the new principal place of work. The term has reference

only to a period of time, and not to the nature of, or reason for, the sale.

Sale differential

The term "sale differential" is defined in paragraph (2) of subsection (c) as the amount by which (A) the appraised value of the old residence exceeds (B) the gross sales price of the old residence reduced by the selling commissions, legal fees, and other expenses incident to the transfer of ownership of the old residence. Expenses incident to the transfer of ownership refer to direct transfer costs borne by the employee. For example, such expenses do not include fixing-up expenses or traveling expenses of the employee or members of his family from or to the location of the old residence for purposes of its sale. In order for section 1003 to apply, the payment must be made by the employer to the employee as a sale differential. Thus, if an employer pays an employee a lump sum for miscellaneous costs relating to a transfer to a new place of work, only so much of such sum as is related to the sale of the old residence qualifies for treatment under section 1003.

Appraised value

The term "appraised value of the old residence", as defined in paragraph (3) of subsection (c), is the average of two or more appraisals of fair market value made, on or after the valuation date and on or before the date on which the sales contract is entered into, by independent real estate appraisers selected by the employer. Such paragraph (3) provides that the appraised value shall not exceed the fair market value of the old residence. The appraisals shall be made as of the valuation date.

Valuation date

The term "valuation date" is defined in paragraph (4) of subsection (c) as the date selected by the employer for purposes of determining the amount to be paid with respect to the sale differential. The date selected by the employer shall be a date which occurs (1) on or before the date the sales contract is entered into and (2) within the forced sale period.

Employer

The term "employer," as defined in paragraph (5) of subsection (c), means the person who employs the taxpayer as an employee at the new principal place of work. The term also includes any predecessor or successor corporation and any parent or subsidiary corporation. The determination of whether a corporation is a parent corporation or a subsidiary corporation shall be made under subsections (e) and (f) of section 425 of the code (added by sec. 222(a) of the bill) but by reference to the date on which the taxpayer commences work as an employee at the new principal place of work rather than as of the time of the granting of the option to which such section 425 relates. Thus, where a 50-percent voting stock relationship exists between the corporation for which the employee worked prior to his transfer and the corporation for which he works after his transfer, he is considered as having been employed by the same employer.

Exchanges

Paragraph (6) of subsection (c) provides that an exchange by the taxpayer or his spouse of an old residence for other property shall be treated as a sale.

Tenant-stockholder in a cooperative housing corporation

Paragraph (7) of subsection (c) provides that "property used by the taxpayer as his principal residence" includes stock held by a tenant-stockholder in a cooperative housing corporation, as those terms are defined in section 216 of the code, but only if the house or apartment which the taxpayer was entitled to occupy by reason of such stockownership was used by the taxpayer as his principal residence.

(d) *Regulations.*—Subsection (d) of new section 1003 provides that the Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of section 1003.

SECTION 232. AMOUNTS RECEIVED FROM EMPLOYER ON SALE OF RESIDENCE OF EMPLOYEE IN CONNECTION WITH TRANSFER TO NEW PLACE OF WORK—Con.

Subsection (a)(2) of section 232 of the bill amends the table of sections of part I of subchapter O of chapter 1 of the code to reflect the addition of section 1003 added by the bill.

(b) *Effective date.*—Subsection (b) of section 232 of the bill provides that the amendments made by subsection (a) shall apply to amounts paid with respect to sales contracts entered into after December 31, 1963, in taxable years ending after such date.

SECTION 233. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY

Section 233 of the bill (sec. 220 of the bill as passed by the House) was approved by your committee without change. For the technical explanation of this section of the bill, see page A–148 of the report of the Committee on Ways and Means on the bill.

SECTION 234. AVERAGING

Section 234 of the bill (sec. 221 of the bill as passed by the House) has been approved by your committee with three exceptions. For the technical explanation of this section of the bill (other than the amendments made by your committee), see page A–168 of the report of the Committee on Ways and Means on the bill.

First, your committee has made technical changes in the definition of the term "capital gain net income" and in the provisions relating to the computation of the alternative tax to reflect the elimination of section 219 (relating to capital gains and losses) of the bill as passed by the House.

Second, your committee has added a provision to the bill as passed by the House to allow an individual whose adjusted gross income for the computation year is under $5,000 and who chooses the benefits of income averaging to elect the standard deduction under section 144 of the code.

Third, your committee has added a provision to the bill as passed by the House restricting, in certain cases, the application of section 170(b)(5) of the code as added by section 209(c) of the bill (relating to 5-year carryover of certain excess charitable contributions by individuals).

Capital gain net income

Paragraph (1) of section 1302(d) of the code, as amended by your committee, provides that the term "capital gain net income" means the amount which is equal to 50 percent of the excess of the net long-term capital gain over the net short-term capital loss. An individual's capital gain net income for any taxable year cannot be less than zero.

Computation of alternative tax

Paragraph (2) of section 1304(e) deals with the method by which an individual computes his alternative tax under section 1201 of the code for any computation year. Paragraph (2), as amended by your committee, provides that if an individual has capital gain net income for the computation year, then section 1201(b) of the code is treated as imposing a tax on the individual's income which is equal to the tax imposed by section 1 of the code, reduced by the amount (if any) by which the amount of the tax imposed by section 1 of the code which is attributable to an individual's capital gain net income for such year (as determined under paragraph (1) of section 1304(e)) exceeds the amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

Amendment of section 144.—Subsection (c) of section 234 of the bill, as approved by your committee, amends section 144 of the code (relating to election of standard deduction) by adding after section 144(c) (as added by sec. 112(c)(2) of the bill) a new subsection (d).

Individuals electing income averaging

Subsection (d) of section 144 provides that if a taxpayer chooses to have the benefits of part I of subchapter Q (relating to income averaging) for a taxable year, section 144(a) of the code (relating to method and effect of election of standard deduction) shall not apply for such taxable year and the standard deduction under section 141 of the code shall be allowed if the taxpayer so elects in his return for such taxable year. The Secretary of the Treasury or his delegate shall prescribe by regulations the manner of signifying such election in the return. If the taxpayer on making his return fails to signify, in the manner prescribed by regulations, his election to take the standard deduction, such failure shall be considered his election not to take the standard deduction.

Effective date.—Subsection (g)(2) of section 234 of the bill, as approved by your committee, provides, in effect, that, in a taxable year beginning after December 31, 1963, if a taxpayer elects to apply both sections 1301 and 1307(e) of the code, as such sections were in effect immediately before the enactment of the bill, then section 170(b)(5) of the code as added by section 209(c) of the bill shall not apply to charitable contributions paid in such taxable year.

SECTION 235. SMALL BUSINESS CORPORATIONS

Section 235 of the bill, which is a new section added to the bill as passed by the House, relates to small business corporations.

(*a*) *Ownership of certain stock disregarded.*—Subsection (a) of section 235 of the bill amends section 1371 of the code (relating to the definition of a small business corporation) by adding a new subsection (d) to permit a corporation to be a small business corporation while owning the stock of certain inactive subsidiary corporations.

Under section 1371(a) of existing law, a small business corporation is not permitted to be a member of an affiliated group. New subsection (d) provides that, for purposes of section 1371(a), a corporation shall not be considered to be a member of an affiliated group at any time during any taxable year by reason of the ownership of stock in another corporation if such other corporation meets the requirements provided in new paragraphs (1) and (2) of section 1371(d).

Paragraph (1) provides that the subsidiary corporation must not have begun business at any time on or after the date of its incorporation and before the close of the parent corporation's taxable year with respect to which status as a small business corporation is being sought. An example of a corporation which "has not begun business" is a corporation which is incorporated for the sole purpose of reserving a corporate name in a State or States in which the parent corporation is not doing business.

Paragraph (2) of section 1371(d) provides, in effect, that the subsidiary corporation must not have taxable income for the portions of any of its taxable years which are included within the taxable year of the parent corporation with respect to which status as a small business corporation is being sought.

Thus, for example, assume that corporation P wishes to elect to be treated under the provisions of sections 1371 through 1377 of the code for its calendar year 1964 and subsequent years. Corporation P owns all of the stock of corporation S, which is on a June 30 taxable year. Corporation P would not be precluded from making an election under section 1372 if corporation S had not begun business before January 1, 1965, and had no taxable income for either the period January 1, 1964, through June 30, 1964, or the period July 1, 1964, through December 31, 1964. Assuming that corporation P so elected with respect to its calendar year 1964, it would cease to be a small business corporation for any subsequent taxable year if corporation S either begins business before the close of such subsequent year, or has taxable income for any period included within such subsequent year.

The enactment of section 1371(d) does not relax or otherwise change the requirements of any of the provisions of subchapter S other than with respect to the requirement that a small business corporation may not be a member of an affiliated group. Thus, in the above example, the election made by corporation P under section 1372 must have been made either during the month of December 1963 or January 1964.

(*b*) *Certain distributions of money after close of taxable year.*—Subsection (b) of section 235 of the bill amends section 1375 of the code (relating to special rules applicable to distributions of electing small business corporations) by adding a new subsection (e).

Paragraph (1) of new section 1375(e) provides that, for purposes of chapter 1 of the code, a corporation which sold capital assets or property described in section 1231(b) of the code during a taxable year with respect to which it was an electing small business corporation may elect to treat as a distribution of money made on the last day of such taxable year, a distribution of money representing all or part of the proceeds of such sales of assets or property which such corporation makes to its shareholders on or before the 15th day of the third month following the close of such year, if such distribution is made pursuant to a resolution of its board of directors adopted before the close of such taxable year. Thus, if a corporation makes such an election, such distribution will be treated as actually distributed and received on the last day of such taxable year and will be taken into account in computing undistributed taxable income (as defined in sec. 1373(c)) for such taxable year to the extent that such distribution is a distribution out of earnings and profits of such taxable year as specified in section 316(a)(2).

Paragraph (2) of new section 1375(e) provides, in effect, that in order for a corporation to make an election under paragraph (1) of new section 1375(e) with respect to any distribution, each person who is a shareholder on the day the distribution is received must own as of the close of such day the same proportion of stock of such corporation as he owned as of the close of the last day of the taxable year of such corporation preceding the taxable year of the distribution, and each such shareholder must consent to such election at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe by regulations.

Paragraph (3) of new section 1375(e) provides that the election under paragraph (1) of new section 1375(e) shall be made in such manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election shall be made not later than the time prescribed by law for filing the return for the taxable year during which the sale was made (including extensions thereof), except that, with respect to any taxable year ending on or before the date of enactment of the bill, such election shall be made within 120 days after such date.

(c) *Effective dates.*—Subsection (c) of section 235 of the bill provides that the amendment made by subsection (a) of such section shall apply with respect to taxable years of corporations beginning after December 31, 1962, and that the amendment made by subsection (b) of such section shall apply with respect to taxable years of corporations beginning after December 31, 1957. No provision of this section of the bill extends the period of limitations within which a claim for credit or refund may be filed for any taxable year.

SECTION 236. REPEAL OF ADDITIONAL 2-PERCENT TAX FOR CORPORATIONS FILING CONSOLIDATED RETURNS

Section 236 of the bill (sec. 222 of the bill as passed by the House) was approved by your committee without change. For the technical explanation of this section of the bill, see page A-186 of the report of the Committee on Ways and Means on the bill.

SECTION 237. REDUCTION OF SURTAX EXEMPTION IN CASE OF CERTAIN CONTROLLED CORPORATIONS, ETC.

Section 237 of the bill (sec. 223 of the bill as passed by the House) was approved by your committee with minor technical changes. For the technical explanation of this section (except for the amendments made by your committee), see page A-187 of the report of the Committee on Ways and Means on the bill.

(*a*) *In general.*—Subsection (a) of section 237 adds a new part II (relating to certain controlled corporations) to subchapter B of chapter 6 of the code.

SECTION 1562. PRIVILEGE OF GROUPS TO ELECT MULTIPLE SURTAX EXEMPTIONS

Additional tax imposed

The bill as passed by the House provides certain exceptions to the general rule that a corporation which is a component member of a controlled group of corporations which has made an election under new section 1562(a) of the code is subject to the additional tax imposed by section 1562(b):

1. New section 1562(b)(1) provided that the additional tax is not to apply to the taxable year of the corporation if such corporation is the only member of the controlled group which has taxable income for the taxable year.
2. Subsection (c) of section 1551 of the code (relating to disallowance of surtax exemption and accumulated earnings credit), as amended by the bill as passed by the House, provided that if the surtax exemption is disallowed to a transferee corporation under section 1551(a) for any taxable year the additional tax is not to apply with respect to such transferee for such taxable year.
3. The bill as passed by the House added a new subsection (d) to section 269 of the code (relating to acquisitions made to evade or avoid income tax) to provide that if the surtax exemption is disallowed under section 269(a) to an acquired corporation for any taxable year the additional tax is not to apply with respect to such acquired corporation for such taxable year.

Your committee has stricken out the provisions referred to in paragraphs (2) and (3), and has added to the provision referred to in paragraph (1) a general rule that the additional tax is not to apply to the taxable year of a corporation if its surtax exemption is disallowed under any provision of subtitle A of the code for such taxable year.

Tolling of statute of limitations

Your committee has made a change in subsection (g) of new section 1562 in order to make it clear that neither the Secretary of the Treasury nor his delegate nor the taxpayer may invoke such subsection for the purpose of overturning closing or compromise agreements. Thus, paragraph (2) of new section 1562(g) relating to the tolling of the statute of limitations for allowing or making claim for credit or refund of any overpayment of tax has been changed by your committee to conform to the provisions of paragraph (1) of such section, relating to the tolling of the statute of limitations for assessment of deficiencies.

SECTION 1563. DEFINITIONS AND SPECIAL RULES

Special rules

Your committee has adopted a new special rule by adding a new subparagraph (C) to new section 1563(f)(3). By reason of this addition, your committee has deleted as unnecessary a provision contained in the first parenthetical expression of section 1563(c)(2)(A)(ii). The new subparagraph (C) of section 1563(f)(3) provides that if stock is owned by a person within the meaning of section 1563(d) and such ownership results in the corporation being a component member of a controlled group, such stock shall not be treated as excluded stock under section 1563(c)(2) if by reason of treating such stock as excluded stock the result is that such corporation is not a component member of a controlled group. Thus, for example, assume corporation P owns directly 50 of the 100 shares of the only class of stock of corporation S. Also assume that O, an officer of corporation P, owns directly 30 shares of such stock and corporation P owns an option to acquire such 30 shares from O. The remaining shares of corporation S (20) are owned by unrelated persons. In the absence of the new special rule adopted by your committee, one possible construction of the applicable provisions of the House bill is that the 30 shares of stock of corporation S owned by O would be treated as excluded stock under section 1563(c)(2)(A)(ii), and corporation P would be treated as owning only 71 percent (50 divided by 70) of the stock of corporation S. Thus, corporation S would not be a component member of a controlled group of corporations within the meaning of section 1563(b). The special rule added by your committee insures, however, that the stock ownership rules contained in section 1563(d) take precedence over the excluded stock rules contained in section 1563(c)(2) when the result is to include a corporation as a component member of a controlled group of corporations which, in the absence of the new special rule, would not be the case. Thus, in the preceding example, O's stock would not be treated as excluded stock with the result that P is treated as owning 80 percent of the stock of corporation S (50 percent directly, and 30 percent constructively under sec. 1563(e)(1)) and corporation S would be a component member of a controlled group of corporations consisting of corporations P and S.

Your committee has also made minor conforming and clarifying changes in new section 1563.

(*b*) *Disallowance of surtax exemption and accumulated earnings credit.*—Subsection (b) of the bill contains amendments to section 1551 of existing law. Subsection (b)(2) of section 1551 as amended by the bill, defines the term "control" in the case of a transferee corporation described in subsection (a)(3) of such section. Subparagraph (B) of section 1551(b)(2) provides, in part, that with respect to voting stock, five or fewer individuals must own stock possessing *more than* 50 percent of the total combined voting power of all classes of stock entitled to vote. However, a slightly different test is provided with respect to the ownership requirements relating to the value of the outstanding stock. The test is that the five or fewer individuals must own stock possessing *at least* 50 percent of the total value of shares of all classes of stock. Your committee has made the voting stock and the value stock tests identical by requiring that in each case the individuals must own more than 50 percent of the particular stock in question.

(c) *Technical amendments.*—Subsection (c) of the bill as reported is the same as subsection (c) of the bill as passed by the House except for a conforming change.

(d) *Effective date.*—Subsection (d) of the bill as reported is the same as subsection (d) of the bill as passed by the House.

SECTION 238. VALIDITY OF TAX LIENS AGAINST MORTGAGEES, PLEDGEES, AND PURCHASERS OF MOTOR VEHICLES

Section 238 of the bill, which is a new section added to the bill as passed by the House, relates to the validity of tax liens on certain motor vehicles.

(a) *Mortgagees, pledgees, and purchasers without actual notice or knowledge of lein.*—Subsection (a) of section 238 of the bill amends section 6323(c) of the code (relating to exception in case of securities) to grant, in the case of the mortgage, pledge, or purchase of a motor vehicle, the same treatment which is now available in the case of the mortgage, pledge, or purchase of a security after notice of a tax lien has been filed. Thus, even though notice of a tax lien imposed by section 6321 has been filed, such lien will not be valid with respect to any mortgagee, pledgee, or purchaser of a motor vehicle, for an adequate and full consideration in money or money's worth, if at the time of such mortgage, pledge, or purchase such mortgagee, pledgee, or purchaser was without notice or knowledge of the existence of such lien.

Paragraph (1) of section 238(a) of the bill amends the heading of section 6323(c) of the code to reflect the extension of the exception contained in such subsection to cover motor vehicles.

Paragraphs (2) and (3) of section 238(a) of the bill amend paragraph (1) of section 6323(c) of the code to extend the exception contained in paragraph (1) to any mortgagee, pledgee, or purchaser of a motor vehicle without notice or knowledge of the existence of a tax lien.

Paragraph (4) of section 238(a) of the bill adds a new paragraph (3) to section 6323(c) of the code. Paragraph (3) defines the term "motor vehicle", as used in section 6323(c), as a vehicle (other than a house trailer) which is registered for highway use under the laws of any State or foreign country.

(b) *Liens for estate and gift taxes.*—Subsection (b) of section 238 of the bill amends section 6324 of the code (relating to special liens for estate and gift taxes) to grant, in the case of the mortgage, pledge, or purchase of a motor vehicle, the same treatment which is now available in the case of the mortgage, pledge, or purchase of a security after a lien for estate or gift tax has arisen. Thus, even though a special lien for estate or gift tax has arisen, such lien will not be valid with respect to any mortgagee, pledgee, or purchaser of a motor vehicle, for an adequate and full consideration in money or money's worth, if at the time of such mortgage, pledge, or purchase such mortgagee, pledgee, or purchaser was without notice or knowledge of the existence of such lien.

Paragraph (1) of section 238(b) of the bill amends section 6324(a) of the code (relating to liens for estate tax) and section 6324(b) of the code (relating to lien for gift tax) to extend the exception for securities now contained in those subsections to motor vehicles.

Paragraph (2) of section 238(b) of the bill amends section 6324(c) of the code (relating to exception in case of securities) by revising such subsection to cover both securities and motor vehicles.

(c) *Effective date.*—Subsection (c) of section 238 of the bill provides that the amendments made by this section apply only with respect to mortgages, pledges, and purchases made after the date of the enactment of the bill.

TITLE III—OPTIONAL TAX ON INDIVIDUALS; COLLECTION OF INCOME TAX AT SOURCE ON WAGES

SECTION 301. OPTIONAL TAX IF ADJUSTED GROSS INCOME IS LESS THAN $5,000

This section has been approved by your committee without change. For the technical explanation of this section of the bill see page A-214 of the report of the Committee on Ways and Means on the bill.

SECTION 302. INCOME TAX COLLECTED AT SOURCE

Section 302 of the bill amends section 3402 of the code (relating to income tax collected at source) and section 1441 of the code (relating to withholding of tax on nonresident aliens).

(a) *Percentage method of withholding.*—Subsection (a) of section 302 of the bill amends section 3402(a) of the code (relating to income tax collected at source). Under the bill as passed by the House, section 3402(a) of the code provided for a 15-percent withholding rate in the case of wages paid during the calendar year 1964 and a 14-percent withholding rate in the case of wages paid after December 31, 1964. Your committee has amended section 3042(a) to provide for a 14-percent withholding rate in the case of wages paid after the seventh day following the date of the enactment of the bill.

(b) *Wage bracket withholding.*—Subsection (b) of section 302 of the bill amends section 3402(c)(1) of the code (relating to wage bracket withholding). Under the bill as passed by the House, section 3402(c)(1) of the code provided new withholding tables for wages paid during the calendar year 1964, and new tables for wages paid after December 31, 1964. Your committee has amended section 3402(c)(1) to provide that the new withholding tables which would have become effective for wages paid after December 31, 1964, under the bill as passed by the House will become effective for wages paid after the seventh day following the date of the enactment of the bill.

(c) *Withholding of tax on certain nonresident aliens.*—Subsection (c) of section 302 of the bill amends sections 1441 (a) and (b) of the code (relating to withholding of tax on nonresident aliens). Under the bill as passed by the House, section 1441(a) of the code provided a 15-percent withholding rate in the case of certain payments made during the calendar year 1964 and a 14-percent withholding rate in the case of certain payments made after December 31, 1964. Your committee has amended section 1441(a) to provide a 14-percent withhold-

ing rate in the case of these payments made after the seventh day following the date of the enactment of the bill.

Under the bill as passed by the House, section 1441(b) of the code referred to the rates of 15 percent or 14 percent provided by the amended section 1441(a). Your committee has amended section 1441(b) to refer to the new 14-percent rate which is provided by amended section 1441(a).

(*d*) *Effective dates.*—Subsection (d) of section 302 of the bill as passed by the House provided that the amendments made by subsections (a) and (b) of such section apply with respect to remuneration paid after December 31, 1963, and that the amendment made by subsection (c) applies with respect to payments made after December 31, 1963. Your committee's amendment provides that the amendments made by subsections (a) and (b) of such section apply with respect to remuneration paid after the seventh day following the date of the enactment of the bill, and that the amendment made by subsection (c) of such section applies with respect to payments made after the seventh day following the date of the enactment of the bill.