75TH CONGRESS } SENATE { REPORT
1st Session } { No. 1242

REVENUE BILL OF 1937

AUGUST 16 (calendar day, AUG. 17), 1937.—Ordered to be printed

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

REPORT

[To accompany H. R. 8234]

The Committee on Finance, to whom was referred the bill (H. R. 8234) to provide revenue, equalize taxation, prevent tax evasion and avoidance, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The committee feels that an explanation of the provisions of the bill is unnecessary, in view of the fact that the committee has reported the bill as passed by the House with amendments with respect to only two matters, and in view of the full and complete report made by the Ways and Means Committee, which is appended to and made a part of this report.

The committee recommends the insertion in section 353 of new title IA, which relates to the gross income of personal holding companies, of a new subsection (sec. 353 (h)) dealing with income from mineral, oil, or gas royalties. The effect of the subsection is to exclude such royalties from personal-holding-company income if they constitute 50 percent or more of the gross income of the corporation. This provision is subject to the limitation that, in order for such income to be excluded, the amount allowable for the taxable year for expenses under section 23 (a) must constitute 15 percent or more of the gross income. Compensation to shareholders for personal services is not to be counted as part of the 15 percent. This amendment will not exclude royalty income if it constitutes less than 50 percent of the gross income, and it is believed that the 15-percent expenses requirement will furnish a satisfactory separation between companies which may be classified as operating companies and the pure holding-company type. The amendment to section 353 (a) is a technical amendment made necessary by reason of the insertion of the new section 353 (h).

The committee recommends that "Sec. 355 (b)" on page 9 of the bill be amended to read as follows:

(b) Amounts used or irrevocably set aside to pay or retire indebtedness of any kind incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness.

The committee agrees with the Ways and Means Committee of the House that the deduction (in arriving at the undistributed adjusted net income of a personal holding company) of amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, should be retained in the bill. The insertion of the words "to pay" and "of any kind" are clarifying amendments to existing law, some controversy having arisen as to the intent of such law. The word "irrevocably" is added to protect the revenue, so that amounts may not be set aside for retirement of debt, and deductions secured, although finally such amounts are never used to retire the indebtedness.

(The report of the House Ways and Means Committee follows:)

75TH CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
1st Session } { No. 1546

THE REVENUE BILL OF 1937

AUGUST 13, 1937.—Committed to the Committee of the Whole House on the state of the Union and ordered to be printed

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Mr. DOUGHTON, from the Committee on Way and Means, submitted the following

REPORT

[To accompany H. R. 8234]

The Committee on Ways and Means, to whom was referred the bill (H. R. 8234) to provide revenue, equalize taxation, prevent tax evasion and avoidance, and for other purposes, report it back to the House without amendment and recommend that the bill do pass.

The need for such a bill was called to the attention of the Congress by the President of the United States in his message dated June 1, 1937. After investigating the matters contained in the President's message, the Joint Committee on Tax Evasion and Avoidance submitted a report to the Congress under date of August 5, 1937, pursuant to Public Resolution No. 40, Seventy-fifth Congress.

The report of the Joint Committee on Tax Evasion and Avoidance contains the following significant statement:

> In order promptly to consider and investigate the matters brought to the attention of the Congress by the above message a joint resolution was introduced providing for the creation of a Joint Committee on Tax Evasion and Avoidance. This joint resolution became law on June 11, 1937. It provided for a joint committee to be composed of six Members of the Senate who are members of the Committee on Finance, and six Members of the House of Representatives who are members of the Committee on Ways and Means. The requisite powers were given the joint committee to hold hearings, to examine documents, and to take testimony. Power was also given the joint committee to examine income-tax returns and related matters. Section 2 of the joint resolution referred to makes it the duty of the joint committee to investigate the methods of evasion and avoidance of income, estate, and gift taxes, pointed out in the message of the President transmitted to Congress on June 1, 1937, and other methods of tax evasion and avoidance, and to report to the Senate and the House, at the earliest practicable date, and from time to time thereafter but not later than February 1, 1938, its recommendation, as to remedies for the evils disclosed by such investigation.
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> The joint committee having considered the subject matter submitted to it submits the following report:
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> The committee has held public hearings, beginning on June 17, 1937. Since that date it has been almost continuously engaged in holding such hearings, or

in considering the subject of tax evasion and avoidance in executive session. Because of lack of time the committee has confined itself for the present to those subjects which may be directly classified under the head of evasion or avoidance, leaving out of account subjects such as community property or percentage depletion which will receive further consideration by the joint committee.

The committee, as a result of its investigations, believes it is imperative at this time that legislation should be enacted in regard to the following subjects, with respect to which it has been shown that certain serious loopholes exist:

1. Domestic personal holding companies.
2. Incorporated yachts, country estates, etc.
3. Incorporated talents.
4. Artificial deductions for losses from sales or exchanges of property.
5. Artificial deductions for interest and business expense.
6. Multiple trusts.
7. Foreign personal holding companies.
8. Nonresident aliens.

Detailed recommendations are made on these subjects in the body of this report. The committee has examined the problem of certain alleged tax-saving devices based on single-premium life-insurance policies issued by fake foreign insurance companies. The committee believes the existing law is adequate to reach these cases. The subject of pension trusts has been passed over for the present because it does not appear to have resulted in much loss of revenue to date. However, this matter will be reported on later.

The printed record of the public hearings held by the committee amply sustains the statements made by the President of the United States in his message. The committee strongly urges that legislation along the lines recommended be enacted at the earliest possible moment in order to protect the revenue, and in order that all may bear their fair share of the tax burden.

Your committee has given careful consideration to the message of the President of the United States and to the report of the Joint Committee on Tax Evasion and Avoidance. Your committee believes that the evidence presented before the joint committee and the Ways and Means Committee fully substantiates the statements made by the President of the United States in his message to the Congress. Your committee concurs in the recommendations made by the joint committee with respect to legislation in all major respects and the bill is designed to carry out these recommendations.

The bill is divided into six titles as follows:

I. Personal Holding Companies.
II. Foreign Personal Holding Companies.
III. Disallowed Deductions.
IV. Trusts.
V. Nonresident Aliens.
VI. Miscellaneous Provisions.

A detailed discussion of each of these titles follows:

Title I—Personal Holding Companies

Section 1 of title I of the bill substitutes, for the taxable years to which it is applicable, a new title IA for the provisions of existing law relating to personal holding companies. Under the new provisions title IA is divided into 10 sections—that is, sections 351 to 360, inclusive. A discussion of each of these sections follows:

NEW SECTION 351, 1936 ACT—SURTAX ON PERSONAL HOLDING COMPANIES

Under existing law, personal holding companies are subject to a surtax at rates ranging from 8 percent upon undistributed adjusted net incomes not in excess of $2,000 to 48 percent in the case of undistributed adjusted net incomes in excess of $1,000,000. These rates

are sufficiently low to permit individuals in the high surtax brackets to secure considerable tax savings, particularly through the formation of multiple personal holding companies. To prevent wealthy individuals from securing tax advantages through the formation of multiple personal holding companies, it is necessary that very high minimum rates be imposed upon personal holding companies. Accordingly, under this section, it is proposed to tax the undistributed adjusted net income of personal holding companies not in excess of $2,000 at a rate of 65 percent, and the remainder over $2,000 at a rate of 75 percent.

NEW SECTION 352, 1936 ACT—DEFINITION OF PERSONAL HOLDING COMPANY

Under existing law, a corporation is taxable as a personal holding company for any taxable year in which it derives 80 percent or more of its gross income from certain specified sources (mainly investments) and at any time during the last half of such taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. This rule has not been entirely satisfactory. It permits a corporation which is taxable as a personal holding company in one year to escape tax entirely as a personal holding company in the following year by making a slight change in the character of its income (for instance, in the following year, the company might derive 79 percent of its gross income from such specified sources instead of 80 percent). This is true although there was no change in the stock ownership of the company, and the change in the sources of the income was so slight as not to affect the company's being availed of as a personal holding company.

To overcome such defects, this section of the bill provides that if in any taxable year the personal holding company income, as defined in section 353 of new title IA, equals 80 percent or more of the total gross income of the personal holding company, the minimum percentage for each subsequent taxable year shall be 70 percent instead of 80 percent until (1) a year in which the corporation does not meet the stock-ownership test (namely, that at any time during the last half of the taxable year, more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals) or (2) for each of three consecutive years less than 70 percent of the gross income is personal holding company income. For example, suppose a corporation during the last half of each of its taxable years (the calendar years 1937, 1938, and 1939) has more than 50 percent of its outstanding stock in point of value owned by five or less individuals. For the calendar year 1937, 85 percent of its gross income constitutes personal holding company income as defined in the bill. For the calendar year 1938, such personal holding company income represents only 60 percent of its total gross income, and for the calendar year 1939 such personal holding company income constitutes 79 percent of its total gross income. Under existing law, this company is taxable as a personal holding company for the calendar year 1937 but not for the calendar years 1938 and 1939.

Under the bill as reported, such a company is taxable as a personal holding company for both the calendar years 1937 and 1939 but not for the calendar year 1938. If, however, the personal holding company income constituted less than 70 percent of the company's gross income for the years 1938, 1939, and 1940, it would not thereafter be

taxable as a personal holding company until a taxable year in which 80 percent or more of its gross income constituted personal holding company income. Moreover, if in any taxable year such a corporation ceased to be a personal holding company because it failed to meet the stock-ownership test (regardless of whether it met the gross income test), it would not thereafter be taxable as a personal holding company until a taxable year in which it again satisfied the stock-ownership test and in which at least 80 percent of its gross income constituted personal holding company income. In all cases the first year for which the determination of its income is applied to ascertain whether in later years it is a personal holding company (even though less than 80 percent of its gross income is personal holding company income) is the first year for which new title IA applies to it.

In defining a personal holding company this section, like section 351 of existing law, exempts from the definition charitable and other corporations (exempt under sec. 101 of the Revenue Act of 1936 from the normal tax and the surtax on undistributed profits), banks as defined in section 104, life-insurance companies, and surety companies.

Foreign corporations meeting the definition of a personal holding company under new title IA are also subject to this surtax. Section 351 of existing law subjects foreign corporations to its provisions. However, a foreign personal holding company, as defined in section 331 of supplement P (see sec. 201 of the bill), is, with respect to a taxable year ending after the date of the enactment of this bill, excluded from new title IA for such year.

NEW SECTION 353, 1936 ACT—PERSONAL HOLDING COMPANY INCOME

In order for a corporation to be classed as a personal holding company, one of the conditions imposed by existing law is that at least 80 percent of its gross income for the taxable year must be derived from royalties, dividends, interest, annuities, and, except in the case of regular dealers in stock or securities, gains from the sale of stock or securities. In section 353 of new title IA, your committee included all of these items under the term "personal holding company income" and adds to that definition certain other items.

These items will now be discussed in detail:

Subsection (a) includes as items of personal holding company income "dividends, interest, royalties, and annuities." These items are the same as those used for the purpose of the 80-percent test under existing law. "Royalties" as used herein has the same meaning as in the case of royalties referred to in section 351 of existing law and, therefore, includes income from copyrights.

Subsection (b) includes as personal holding company income gains from the exchange of stock or securities. This is merely a clarifying amendment to carry out the intent of existing law.

Subsection (c) includes as personal holding company income, gains derived from futures transactions in commodities on or subject to the rules of boards of trade and exchanges. However, an exception is made in the case of gains on bona-fide hedging transactions derived by corporations engaged in good faith in producing, processing, merchandising, or handling such commodities. Gains from cash transactions are not included. Evidence was submitted to the joint committee which disclosed that corporations, which in all respects except

the income test were personal holding companies, derived enough of their income from speculative futures transactions to enable them to fall outside the income test.

Subsection (d) includes as personal holding company income, income required to be taken up by a corporate beneficiary from an estate or trust as well as gains from the sale or other disposition of any interest of the corporation in an estate or trust. The present law makes no reference to income of corporations from estates or trusts. It is possible, therefore, that the personal holding company section might be circumvented by creating a trust which pays its income to the corporation. Under such circumstances, it might be contended that under existing law a corporation receiving more than 20 percent of its gross income from estates and trusts was not a personal holding company. By including trust and estate income within the definition of personal holding company income, your committee amendment closes this possible loophole.

Subsection (e) includes in personal holding company income certain amounts received by a corporation from contracts for personal services (including gain from the sale or other disposition thereof). Existing law contains no comparable provisions. To make such income includible as personal holding company income, the following conditions must exist:

(1) Some person other than the corporation must have the right to designate (by name or by description) the individual who is to perform the services, or the individual who is to perform the services must be designated (by name or description) in the contract; and

(2) The individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform such services, must at some time during the taxable year of the corporation own, directly or indirectly, 25 percent or more in value of the outstanding stock of the corporation.

Evidence was presented to the committee of instances where an individual with unique talents, whose compensation for personal services was large, formed a corporation which contracted with him for his services at a relatively modest figure, and then contracted out his services with third persons at a much higher figure. The corporation accumulated the difference between the sums received and the sums paid to the individual, and under existing law paid only the corporate normal and undistributed-profits taxes thereon, since the corporate income from its contract for services did not come within the classes of income described in section 351 of existing law. It is necessary to provide that the individual may be designated by description as well as by name, as some contracts may so describe the individual that his identity could not be mistaken, although his name was not mentioned. The provision that some third party must have the right to designate who shall perform the services contracted for, or that the person to perform the services must be designated in the contract, will prevent this rule from applying in general to operating corporations engaged primarily in rendering personal services and which necessarily enter contracts to render such services, selecting such members of their staff as they desire to render such services. Thus, corporations which let out the services of architects, engineers, and advertisers would not as a general rule be required to report such income as personal holding company

income. It is believed that the proposed amendment will take care of the "incorporated talent" loophole.

Subsection (f) includes in personal holding company income amounts received as compensation for the use of, or the right to use, the property of the corporation. However, this rule only applies where during the taxable year of the corporation, 25 percent or more in value of its outstanding stock is owned, directly or indirectly, by an individual leasing or otherwise entitled to the use of the property. It makes no difference whether the right to use the property is obtained by the individual directly from the corporation or by means of a sublease or other arrangement. Since under existing law, this type of compensation is not now included for the purpose of determining whether the corporation meets the 80-percent test, the taxpayer may fix such compensation in an amount sufficient to bring its other investment income below the 80-percent test. It has been shown to the committee that this device has been employed by taxpayers who had incorporated their yachts, city residences, or country houses and had paid sufficient rent to give the corporations enough income from their service to take them out of present section 351. By including this type of income in the definition of personal holding company income, your committee removes this method of tax avoidance.

Subsection (g) includes as personal holding company income, rents which do not constitute 50 percent or more of the gross income. For this purpose, rents are defined as compensation, however designated for the use of, or right to use, property. But rents do not include compensation received for the use of property covered by subsection (f) (rent of yachts, airplanes, etc., to shareholders). Under existing law, rents are excluded from the 80-percent classification. This was done principally so as not to interfere with bona-fide and legitimate operating companies, whose business consisted of the ownership and operation of office buildings, apartment houses, etc. However, your committee believes that the entire exemption of rents from this classification has permitted certain personal holding companies which are not bona-fide operating companies, to escape their just share of the tax burden. To prevent certain holding companies which are not bona-fide operating companies from taking advantage of this exception and to protect legitimate operating companies, the proposed bill provides that rents be included in the definition of personal holding company income unless they constitute 50 percent or more of the gross income of the corporation. This will prevent a corporation from getting out of title IA by investing just enough in rents to constitute the gross income therefrom, 21 percent of the total, and still deriving the remainder of its income from dividends, interest, etc. On the other hand, it will protect the bona-fide real-estate corporation and other corporations renting property and deriving 50 percent or more of their gross income from rents. "Rents" as here used is defined in its broadest sense and includes such items as charter fees, etc., and is not limited to rent of real property.

NEW SECTION 354, 1936 ACT—STOCK OWNERSHIP

Under the proposed title IA, it is necessary to ascertain the ownership of stock for the following purposes:

(1) To determine whether during the last half of the taxable year more than 50 percent in value of the outstanding stock is owned directly or indirectly by or for not more than five individuals (sec. 352 (a) (2)).

(2) To determine whether or not 25 percent or more in value of the outstanding stock of a corporation is owned directly or indirectly by or for an individual whose services are furnished such corporation to some other person (sec. 353 (e)).

(3) To determine whether 25 percent or more in value of the outstanding stock of a corporation is owned by or for an individual using or having the right to use the property of a corporation for which the corporation is paid compensation (sec. 353 (f)).

Section 354 of new title IA sets forth the rules for determining the ownership of stock of an individual where he has the constructive and not the actual ownership of such stock, and the rules governing the treatment of other obligations of the corporation which are considered to be outstanding stock.

The provisions discussed below establish methods of bringing into the ownership of an individual stock actually or constructively owned by others. As under title IA of the present law, it is not necessary that the individual who may be counted to make five individuals, under the constructive ownership rules, actually own stock himself. To exclude the case where he owned no stock would permit avoidance by the employment of the device of placing the stock in others whose actions would be subject to the individual's control because of the family or other relationship existing between him and the actual owner.

Paragraph (1) of subsection (a) provides that stock owned directly or indirectly by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. This is the same rule which is applied under section 351 of existing law for the purpose of determining the ownership of stock in a personal holding company. Its effect is explained by the following example: Corporation A owns all the stock of corporation B. In determining whether or not, and the extent to which, the stock of corporation B is considered to be held by individuals the proposed amendments look through corporation A and provide, in effect, that the stock of corporation B is owned by the shareholders of corporation A instead of by corporation A, itself. A similar rule is applied in a case in which the stock is held by a partnership, estate, or trust—the partners or beneficiaries are deemed to own the stock. The rule applies to the portion of the stock of B owned by A, and the rule also applies if there is a chain of corporations.

Paragraph (2) of subsection (a) deems stock owned directly or indirectly by or for the family of an individual or by or for his partner as owned by the individual himself. This is the same rule which is applied under section 351 of existing law for the purpose of determining stock ownership except that the rule is broadened to include the stock of the partner of such individual. Because of the close business relationship existing between members of a partnership, your committee is of the opinion that it is proper to extend the provision so as to include in determining the ownership of stock by an individual the stock owned by or for a partner of such individual. The definition of "family" for the purpose of this rule is the same as that contained in section 351 of existing law. It therefore embraces all members of the family in the direct line as well as brothers and sisters (whether of the whole or half blood) and spouse.

Paragraph (3) of subsection (a) provides that if any person has an option to acquire stock such stock may be considered as owned by

such person. The term "option" as used in this paragraph includes an option to acquire such an option and each one of a series of such options, and so the person who has an option on an option may be considered an owner of the stock. Under existing law, some individuals try to circumvent the provisions of section 351 by splitting up the ownership of stock among more than five individuals but giving less than five individuals an option to acquire the stock at any time they desire. For example, five individuals may own 49 percent of the value of the outstanding stock of a corporation and one of them may have an option to acquire 2 percent or more in value of the shares. In such a case, they are for all practical purposes in the same situation as if they owned 51 percent in value of the stock. If the stock which such individual had a right to acquire by option was added to the other shares actually owned by him, there would be a sufficient stock ownership to bring the company within the personal holding company stock ownership test. The amendment proposed by your committee adopts such a rule.

Paragraph (4) of subsection (a) provides, in effect, that the family and partnership rule referred to in paragraph (2), as well as the option rule referred to in paragraph (3), may or may not be applied, depending upon whether they are necessary to produce the smallest number of individuals required to make the corporation a personal holding company or to make the receipt of income derived from personal-service contracts or from the use of property by shareholders, includible as personal holding company income. For example, where five or less individuals own more than 50 percent in value of the outstanding stock of the corporation during the last half of the taxable year, it will not be necessary to apply either the family rule or the option rule. In some cases, the application of the option rule might bring the corporation within the personal holding company class, whereas the application of the family rule would not. In such cases, the option rule would be applied and not the family rule.

Paragraph (5) of subsection (a) provides that stock constructively owned by a person by reason of the application of the rule in paragraph (1) (relating to stock owned by a corporation, etc.) or the option rule contained in paragraph (3) may be used again for the purpose of applying either the paragraph (1) rule or the paragraph (2) rule relating to family and partnership ownership. However, stock constructively owned by an individual because of the application of the family and partnership rule may not be used again for the purpose of applying such family and partnership rule to another individual.

For example, if A owns 50 percent of the stock of corporation X and the latter in turn owns 50 percent of the stock of corporation Y, the individual A is considered, by virtue of his stock ownership in X to own his proportionate share of the Y stock owned by X. In this example, A's proportionate share of the Y stock would be 50 percent of 50 percent, or 25 percent. This rule applies regardless of the number of corporations in the chain. Thus, if in the above example, Y owned 50 percent of the stock in corporation Z, the individual A would be considered, by virtue of his constructive ownership of stock in Y, as owning a proportionate share of the Z stock, which in this case would be 50 percent of 50 percent of 50 percent, or 12½ percent. Similarly, the same result follows from the application of the rule with respect to options to acquire stock. If in the foregoing examples

A did not own the X stock but instead held an option to acquire 50 percent of the stock in X and if the facts otherwise were not changed, A would still be considered as owning 25 percent of the Y stock and 12½ percent of the Z stock. In both cases, whether A actually owns the 50-percent interest in X or merely has an option to acquire such interest, his constructive ownership of the Y stock and the Z stock (as well as the constructive ownership of the X stock under the option rule) would be subject to the family rule. That is, A's wife or any other member of his family could be considered, under the family rule as constructively owning the stock constructively owned by A in any of these corporations.

However, stock constructively owned by an individual through application of the family rule may not be considered as actually owned by such individual for the purpose of making some other person the constructive owner of such stock. If an individual B, his wife W, and her father WF each own 10 percent of the stock in corporation M, the wife W may be considered as owning constructively the stock held by her husband, B, and her father WF. But, while the family rule might also be applied to B so that he would be considered as owning his wife's stock, such application would be confined to the stock actually owned by W and could not operate to make B own constructively the stock of WF considered to be constructively owned by W. In the same manner, WF could be considered as owning constructively the stock actually owned by W but not the stock of B constructively owned by W. Thus, because of the absence of a direct link between B and WF, these individuals would each own constructively only 20 percent, whereas W, because of her relationship to B and WF would be considered as constructively owning 30 percent. Of course, whether B, or W, or WF would be counted as the dominant person would depend upon the stockholdings of other pertinent relatives, if any.

Paragraph (6) of subsection (a) provides that if the stock may be considered as owned by an individual by applying either the option rule or the family and partnership rule, it shall be considered as owned by him under the option rule and not under the family or partnership rule. The reason for this rule is evident from the following example:

Assume that two brothers, A and B, each own 10 percent of stock in corporation X and that A's wife, AW, also holds 10 percent, on which her husband, A, has an option to acquire at any time. Assume further that it becomes necessary to determine the stock ownership of B. Under the family rule B would be considered as constructively owning 20 percent, or the 10 percent actually owned by him plus A's 10 percent constructively owned by him. Under such rule, while A would be considered as constructively owning his wife's 10 percent, that interest could not be included in computing B's stock ownership. However, since A has an option to acquire his wife's stock, he may, as the option holder and without reference to the family relationship, also be considered as constructively owning his wife's stock. Inasmuch as constructive ownership under the option rule is in all respect equivalent to actual ownership, AW's 10 percent, if A is deemed to constructively own his wife's stock under the option rule rather than the family rule, could be included in computing B's stock ownership so as to bring his total up to 30 percent.

Subsection (b) of section 354 provides that outstanding securities convertible into stock, whether or not convertible during the taxable

year, may be considered as outstanding stock. Because these securities are considered as outstanding stock, the rules which apply in arriving at stock ownership also apply to these securities, including the family and partnership rule as well as the option rule. However, these securities may or may not be considered as outstanding stock, depending upon whether it is necessary so to consider them in order to make the corporation a personal holding company or to permit the inclusion of income from personal service contracts or from the use of property by shareholders as personal holding company income. The reason for this rule is that it appears that the real owners of certain of these incorporated pocketbooks may own bonds, debentures, or other corporate obligations which contain provisions under which they may be converted into stock. Without such a rule, it might be possible for the company to escape classification as a personal holding company by having its stock held by more than five individuals and at the same time having the interest of the real owner represented by convertible securities.

Where some of the securities are convertible at a later date than others, the rule provides that the class having the earlier conversion date may be included without the inclusion of the others, with the qualification that no convertible securities shall be included unless all such outstanding securities having a prior conversion date are also included. For example, where outstanding securities are convertible in 1937, 1938, and 1939, those convertible in 1937 can be included without including those convertible in 1938 or 1939, and those convertible in 1937 and 1938 can be included without those convertible in 1939. However, the rule would not permit the inclusion of the securities convertible in 1938 without including those convertible in 1937 or permit the inclusion of the securities convertible in 1939 without the inclusion of those convertible in 1937 and 1938. The reason for this rule is that the securities with the earlier conversion date are more likely to be held by those who control the corporation.

It is to be noted that in this title wherever any outstanding security which is not stock but which, under the provisions of the title is considered outstanding stock, the rules relating to outstanding stock apply as if it were stock.

NEW SECTION 355, 1936 ACT—UNDISTRIBUTED ADJUSTED NET INCOME

This section defines the term undistributed adjusted net income. This is the amount upon which the tax under title IA is based. The provision proposed is the same as existing law except in the following respect: Under existing law, a personal holding company is allowed a deduction of 20 percent of the excess of the adjusted net income over the amount of dividends received from other personal holding companies. For example, if the adjusted net income of a personal holding company in excess of dividends received from other personal holding companies is $10,000,000, 20 percent or one-fifth of this amount, namely, $2,000,000, may be accumulated without the payment of any personal holding company surtax whatever. The bill does not allow this deduction.

The bill does not carry out a recommendation of the Joint Committee on Tax Evasion and Avoidance that there should be eliminated the deduction (in ariving at undistributed adjusted net income of a

personal holding company) of amounts used or set aside to retire indebtedness incurred before January 1, 1934. While recognizing the reasons which impelled the joint committee to make this recommendation, your committee feels, from further study of the question, that the denial of this deduction would cause hardship in numerous cases where, due to the particular circumstances of the corporation, a dividend distribution cannot be made because of a necessity for legal reasons of using the earnings and profits to discharge the debts. Moreover, any loss of revenue caused by the continued allowance of this deduction cannot increase, since indebtedness incurred after 1933 cannot be used as a basis for the deduction. No corporation can be formed for the purpose of taking advantage of this deduction. Furthermore, it is inevitable that the revenue loss must decrease as pre-1934 debts are retired. It is the hope of your committee that further study of the problem will disclose a solution whereby the deduction may be denied in the usual case but permitted in case its denial seems unjustifiable. This deduction is not allowed in the case of foreign personal holding companies.

NEW SECTION 356, 1936 ACT—ADJUSTED NET INCOME

This section defines adjusted net income.

The term adjusted net income is also defined in section 351 of existing law, and the following changes in that definition are made by this section:

(1) Under existing law a personal holding company is allowed as a deduction in computing its adjusted net income not only ordinary Federal income and profits taxes paid during the taxable year but also the special tax under section 102 of the Revenue Act of 1936 (or a corresponding provision of a prior revenue act) which imposes a surtax on corporations improperly accumulating surplus. Although section 102 does not apply to a corporation for a taxable year during which it is subject to the provisions of section 351, it is possible for a corporation taxable for the current year under section 351 to pay during such year taxes assessed against it under section 102 for years prior to that during which the corporation was a personal holding company. Thus a corporation may greatly reduce its surtax under section 351 by taking deductions for taxes paid for back years under section 102. Since the tax under section 102 is computed upon undistributed profits for back years it is believed it should be paid out of accumulated earnings and profits rather than out of the current earnings and profits of the corporation for the taxable year. Therefore, a provision of the bill (sec. 356 (a) (1) of new title IA) disallows personal holding companies a deduction for taxes imposed by section 102 but paid within the taxable year.

(2) Under existing law a personal holding company is allowed an unlimited deduction for charitable and other like contributions made within the taxable year to or for the use of donees described in section 23 (q). The bill restricts the deduction to contributions to the same charities with respect to which the deduction is allowed a corporation, to an amount not in excess of 15 percent of the net income of the corporation, thereby giving the personal holding company the same percentage deduction as in the case of an individual. For such purpose, as in the case of the individual, the deduction is computed

without subtracting the amount of it from gross income, and in this case, without subtracting the amounts disallowed under subsection (b), relating to expenses disallowed. While corporations now enjoy a deduction of 5 percent of their net income for the amount of such contributions, personal holding companies are not under the bill entitled to this 5-percent allowance for the purpose of this tax but are limited to the 15-percent allowance. An exception to the denial of the full charitable deduction is made under this section which retains the special provision inserted in 351 (b) (3) (B) of the Revenue Act of 1936 which grants an unlimited deduction, in the case of a corporation organized prior to January 1, 1936, to take over the assets of the estate of a decedent, for amounts paid in liquidation of any liability of the corporation based upon the liability of the decedent to make a contribution or gift to charity, to the extent such liability of the decedent existed prior to January 1, 1934. Your committee believes the retention of this special provision is justified on the ground that the deduction will not inure to the benefit of any private individual. This deduction and the charitable deduction are not allowable for the same year.

(3) Under existing law a personal holding company is allowed in computing its adjusted net income an unlimited deduction for losses from sales or exchanges of capital assets. If such losses were incurred by an individual, they would be allowed under existing law only to the extent of $2,000 plus the gains from such sales or exchanges. By disallowing the unlimited deduction, the bill makes the provision the same as in the case of an individual.

Under subsection (b) of section 356 of new title IA there is disallowed as a deduction from gross income, the expenses of operation and maintenance (including depreciation) of property owned or operated by a personal holding company to the extent that the expenses exceed the rent or other compensation for the use of such property, unless it is established to the satisfaction of the Commissioner—

(A) That the rent or other compensation received is the highest obtainable or if none was obtained that none was obtainable;

(B) That the property was held in the course of business carried on bona fide for profit; and

(C) That there was reasonable expectation that the operation of the property would result in a profit, or that such property was necessary to the conduct of the business.

To prevent a personal holding company from charging expenses in excess of its income from the operation and maintenance of property, such as yachts, city residences, country estates, etc., against its investment income, such expenses should be disallowed unless the corporation can meet the conditions outlined above. This has the effect of placing the personal holding company on the same basis, in this respect, as an individual who cannot offset his personal (as contrasted with business) expenses against his income. If the corporation establishes to the satisfaction of the Commissioner that the second test is satisfied and that the property was necessary to the conduct of such business, it will not be necessary to prove there was reasonable expectation that the operation of the property would result in a profit, in order to obtain a full deduction.

This provision would not apply to an enterprise such as a farm or a racing stable operated by the corporation itself where more than 20 percent of the gross income of such corporation came from such opera-

tions. This is because the corporation must first be a personal holding company before this provision will apply. Moreover, even if such a corporation might be a personal holding company because more than 80 percent of its income came from investment sources, it would still have the opportunity of escaping this provision by establishing that the property was held in the course of a bona-fide business carried on for profit and that such property was necessary for the conduct of the business. The situation of the corporation in such cases remains essentially the same as that of taxpayers under existing law, who are required to prove that expenses for which deductions are claimed are ordinary and necessary and paid or incurred in carrying on a trade or business for a profit. Even where an investment corporation is running a yacht, city residence, or country estate on the side, it is, nevertheless, recognized that certain property may be necessary for the conduct of its investment business, such as typewriters, office furniture, automobile, and the like. Expenses attributable to such property would satisfy the third test.

NEW SECTION 357, 1936 ACT—MEANING OF TERMS USED

This section provides that the terms used in the new title IA shall have the same meaning as where used in title I of the Revenue Act of 1936, relating to the income tax. It is the same as the corresponding provision of existing law.

NEW SECTION 358, 1936 ACT—ADMINISTRATIVE PROVISIONS

This section is the same as section 351 (c) of existing law. It makes the income-tax provisions of title I applicable insofar as not inconsistent with title IA, with the exception that the foreign-tax credit is disallowed.

NEW SECTION 359, 1936 ACT—IMPROPER ACCUMULATION OF SURPLUS

This section contains a cross reference to section 102.

SECTION 2 OF THE BILL—CHANGES IN CROSS REFERENCE

This is merely a clerical amendment making certain changes in cross references.

SECTION 3 OF THE BILL—EFFECTIVE DATES

This section applies the amendments to title IA of the Revenue Act of 1936 by this title only to taxable years beginning after December 31, 1936. It also makes it clear that title IA of the Revenue Act of 1936 prior to such amendment shall not apply to a foreign personal holding company as defined in section 201 of the bill, with respect to any taxable year ending after the date of the enactment of the bill.

TITLE II—FOREIGN PERSONAL HOLDING COMPANIES

Title II of the bill deals with foreign personal holding companies. The evidence presented to the joint committee has shown that foreign personal holding companies have afforded one of the most flagrant

loopholes for tax avoidance. The use of such corporations has greatly increased within the last few years. Unless immediate preventive measures are taken increased loss of revenue will be suffered in the future. Therefore, this subject has received special attention by your committee. On account of lack of direct jurisdiction over such companies, substantial difficulties have been encountered. Your committee is of the opinion that it is justifiable on all grounds, including constitutional grounds, to provide for a method of taxation which will reach the shareholders who own stock in such companies and over whom the United States has jurisdiction. A new method of taxation is therefore proposed under the bill which treats the income of the foreign corporate entity as the income of the shareholders within the jurisdiction of the United States and requires them to report as their income the undistributed net income of such foreign personal holding companies.

SECTION 201 OF THE BILL

This section amends title I of the Revenue Act of 1936 by adding after supplement O a new supplement P dealing with foreign personal holding companies and their shareholders. An explanation of the provisions of this supplement follows:

NEW SECTION 331, 1936 ACT—DEFINITION OF FOREIGN PERSONAL HOLDING COMPANY

Section 331 defines a foreign personal holding company as a foreign corporation which meets the following two requirements:

(1) *Gross-income requirement.*—At least 60 percent of the gross income of the foreign personal holding company for the taxable year must be derived from dividends, interest, royalties, annuities, and other income as specified in section 332. The items of gross income used for this determination are the same as in the case of personal holding companies subject to new title IA.

A provision similar to one described in the case of personal holding companies subject to new title IA (see discussion above under "New section 352") provides that if a foreign personal holding company has for 1 year once satisfied the 60-percent gross-income test, the minimum percentage for subsequent years shall be 50 percent until a taxable year during the whole of which the stock-ownership test is not satisfied or until the expiration of 3 consecutive years in each of which less than 50 percent of the gross income is foreign personal holding company income. This proposal is made to prevent companies from going in and out of the foreign personal holding company classification merely by small changes in the character of their income.

The bill also provides for the inclusion in gross income (for the purpose of determining the gross income to which the above percentage tests are to be applied) of the distributive share of the corporation in the undistributed income of a foreign personal holding company in which it is a shareholder. For a detailed explanation see below under heading "New section 334" and subheading "Gross income test."

(2) *Stock-ownership requirement.*—In order to come within the foreign personal holding company definition, at some time during the taxable year more than 50 percent in value of the outstanding stock of the company must be owned, directly or indirectly, by or for

not more than five individuals who are citizens or residents of the United States (hereinafter called the "United States Group"). (See discussion under "New section 333" for provisions governing the determination of stock ownership.)

A corporation which is exempt from taxation under section 101 of existing law is not in any case to be classed as a foreign personal holding company (sec. 331 (b)).

NEW SECTION 332, 1936 ACT—FOREIGN PERSONAL HOLDING COMPANY INCOME

Section 332 defines "personal holding company income" in exactly the same way as it is defined in section 353 of the Revenue Act of 1936 as amended by title I of this bill.

NEW SECTION 333—STOCK OWNERSHIP IN A FOREIGN PERSONAL HOLDING COMPANY

Section 333 sets forth the provisions governing the determination of stock ownership for the purposes of ascertaining whether a foreign personal holding company's stock is owned by a United States group, and whether amounts receivable from personal service contracts or for the use of corporation property are includible as foreign personal holding company income. These provisions are the same as those provided in the case of personal holding companies subject to title IA. See discussion "New section 354."

NEW SECTION 334, 1936 ACT—GROSS INCOME OF FOREIGN PERSONAL HOLDING COMPANIES

Section 334 (a) provides, for the purposes of the new supplement, the gross income of a foreign corporation shall be computed as if it were a domestic corporation. This means that income from all sources, both within and without the United States, is included in a foreign corporation's gross income. Such a provision is necessary in order to prevent citizens and residents avoiding their proper share of the tax burden by placing their foreign securities in a foreign corporation. If dividends were declared by such a foreign corporation, United States shareholders would be taxable on the entire amount received without regard to the source of the corporate earnings of the corporation. Since the new plan proposes that the undistributed income of the foreign personal holding company shall be considered distributed as a dividend, it follows that, in computing the corporate net income, gross income should not be limited to that from sources within the United States. Computing the gross income as if the corporation were a domestic corporation also means that interest on obligations of the United States, notwithstanding the provisions of section 4 of the Victory Liberty Loan Act of March 3, 1919, amending section 3 of the Fourth Liberty Bond Act of July 9, 1918, is included. This is believed justified and is in no sense a violation of the exemption contained in the Liberty Loan Act since such interest is a part of the corporate earnings available for dividends and under well-settled law would lose its identity and exempt character if it were distributed as a dividend.

Since the principle of the proposed addition of the supplement to the Revenue Act of 1936 is that the undistributed income of foreign personal holding companies is to be included in their incomes by United States shareholders, it is necessary that the supplement provide means by which the amount to be included is ascertained. The amount of the gross income determined as described above is the basic figure for that calculation. In the simple case that amount minus deductions and minus the dividends paid credit is the amount the American shareholders include. The simple case is one where all the stock of a foreign personal holding company is owned by one United States shareholder and no other foreign corporation need be considered. In order to prevent the use of a chain of corporations to avoid a statute which would be written only for the simple case, it is necessary to provide for circumstances where the foreign personal holding company in which the United States shareholder owns stock in turn owns stock in another foreign personal holding company and so down through a chain of foreign personal holding companies. Section 334 (b), recognizing such a possibility, provides for including in the income of a foreign personal holding company the undistributed amount of the income of any foreign personal holding company in which it owns stock. This subsection is designed to reach down through a chain of corporations to bring the income of foreign personal holding companies into the foreign personal holding company, the income of which is treated as income of American stockholders.

Examples of the application of these subsections follow:

Suppose A, a citizen of the United States, owns all the stock of X, a foreign personal holding company. X in turn owns all the stock of Y, another foreign personal holding company. Corporation Y has earnings consisting of dividends and interest, upon stock and securities of other domestic and foreign corporations, for the taxable year of $100, none of which is paid out in dividends. Corporation X has received income for its taxable year of $100 from dividends and interest but makes no distribution. Under the proposed rule, in computing the net income of corporation X it would be necessary to include in its gross income its distributive share which is undistributed of the net income of Y. Assuming that X's only deduction is $10 on its dividends from sources within the United States withheld at the source, corporation X's undistributed supplement P net income for the year would be $190, which is the amount the American stockholder A would be required to include in gross income in his return. If, however, in the above example corporation Y derived $45 of its $100 income, or 45 percent, from the operation of a business as distinguished from investments, it would not be a foreign personal holding company and corporation X would not be required to include in its gross income any part of Y's income of $100. If corporation Y paid no dividends to corporation X the undistributed supplement P net income of X would be only $90, which would be the amount A would have to report as gross income in his return.

Similarly, if corporation Y in the first example owned stock in Z, another foreign personal holding company, Z's income would be held to be constructively received by Y to determine the undistributed income of Y which is to be included in the gross income of X.

In the above examples, X is a "first company" within the meaning of section 334 (b) for the purposes of adding Y's undistributed income to it and Y is a "second company." Y is a "first company" for the

purposes of ascertaining the amount to be included in its gross income on account of its distributive share of Z's undistributed income.

In the application of provisions of subsection (b), only the undistributed income of foreign personal holding companies is included in the gross income of foreign corporations which own stock in them. That is, if the company, the undistributed income of which is to be included in the income of another, does not have a type of income which would make it a foreign personal holding company, none of its undistributed income is to be included in the gross income of another.

Gross-income test.—An important extension of the above rules is to be noted (sec. 334 (c) (2)). Suppose United States citizen A owns all of the stock of X which is a foreign corporation. Since X is owned 100 percent by an American citizen, it satisfies the stock-ownership-requirement test. If it meets the gross-income test of 60 percent foreign personal holding company income it will be a foreign personal holding company. Does it meet such test? Suppose its gross income from actual receipts is $50, $35 from manufacturing operations, and $15 from interest. Without more it does not meet the test. But suppose it owns 90 percent of Y, a foreign personal holding company whose undistributed income is $100, all of its gross income being from interest. Section 334 (c) (2) provides that for the purpose of determining whether corporation X meets the gross-income test, there shall be included in its gross income, as a dividend, its pro-rata share of the $100 ($90) which it did not receive. Its gross income therefore becomes $140, of which $35 is manufacturing income and $105 from interest and dividends. More than 60 percent of its gross income is foreign personal holding company income, and therefore it is a foreign personal holding company. Section 334 (b) then operates for tax purposes, and the $90 remains in the gross income of corporation X for the purpose of determining its undistributed income, which is to be included in the gross income of United States citizen A who owns all the stock of corporation X.

If the above example be changed so that the undistributed income of corporation Y is only $10 instead of $100, the application of the rule above stated makes the gross income of corporation X $59 ($50 plus 90 percent of $10), only $24 ($15 plus $9) of which is foreign personal holding company income. This is less than 60 percent of the total of $59, and hence corporation X does not meet the gross income test, is not a foreign personal holding company, and none of its undistributed income is included in the gross income of United States citizen A who owns all the stock.

The rule above stated is to be successively applied in the case of a chain of foreign corporations. Thus, in the above examples, if corporation Y owns stock in Z, a foreign personal holding company, then (for the purpose of determining whether Y is a foreign personal holding company) the undistributed income of Z is to be included in the gross income of Y. In such case, for the purpose of applying section 334 (b) (as required by sec. 334 (c) (2)) Y would be considered a "first company" and Z would be considered a "second company." Further, it makes no difference whether the same United States group exists with respect to the company whose income is augmented (X) and the company (Y) whose undistributed income is held to have been received. All Y need be is a foreign personal holding company

under the ownership and income rules. All X need be is a foreign personal holding company under such rules before (or with the addition of its share of Y's undistributed income, after) the addition of income considered to be received from Y as a dividend.

In cases where one company (X) is considered to have received as a dividend the undistributed income of another (Y), the amount it is considered to have received is, of course, its pro rata share of that income. If the United States group ceased to exist in the second company (Y) during Y's taxable year, the amount which is includible as having been received by X is X's pro rata share of that part of Y's undistributed income which bears the same ratio to Y's entire undistributed income as the period up to and including the last day of Y's taxable ~~year in which~~ a United States group existed bears to Y's entire taxable year.

NEW SECTION 335, 1936 ACT—UNDISTRIBUTED SUPPLEMENT P NET INCOME

Section 335 defines "undistributed supplement P net income", which is the term used to describe the amount their distributive shares of which the United States shareholders are required to include in their returns although not distributed to them, and the amount which is considered to have been distributed by foreign personal holding companies, not only for the purpose of including amounts in the income of United States shareholders, but also for the purpose of ascertaining the gross income of other foreign personal holding companies in which that amount is included under section 334. The term is defined to mean "supplement P net income" (see discussion of sec. 336) minus the dividends-paid credit allowed in section 27 computed without the benefit of subsection (b) thereof (relating to the dividend carry-over).

NEW SECTION 336, 1936 ACT—SUPPLEMENT P NET INCOME

Section 336 defines "supplement P net income." As explained above, this is the amount from which the dividends-paid credit is subtracted in order to ascertain the amount required to be included in the gross income of the shareholders of a foreign personal holding company. The term is defined to mean the net income (that is, gross income minus deductions) with the following adjustments. Additional deductions as follows are allowed:

(1) Federal income, war profits and excess-profits taxes (see explanation under title I, sec. 356).

(2) Contributions or gifts (charitable contributions) made within the taxable year to or for the use of donees described in section 23 (q) for the purposes therein specified to an amount which does not exceed 15 percent of the company's net income computed without regard to section 23 (q) or the subsection allowing the deduction and without deducting the amounts disallowed under subsection (b), the deductions described below. (See explanation under sec. 356.) For the purpose of this computation, the constructive income considered to have been received as provided in section 334 (b) is ignored.

The following deductions are not allowed:

(1) The deductions provided in section 23 (d), relating to taxes of a shareholder paid by the corporation, and in section 23 (p), relating

to pension trusts. These deductions appear unnecessary and inapplicable with respect to this class of corporations.

(2) Expenses and depreciation. This provision is the same as the comparable provision in title IA and is explained in connection with section 356 of that title.

NEW SECTION 337, 1936 ACT—CORPORATION INCOME TAXED TO UNITED STATES SHAREHOLDERS

The undistributed supplement P net income of a foreign personal holding company is taxed to its United States shareholders under section 337. It is believed that in the ordinary case the stock of a foreign personal holding company is owned by the American individual (including the members of his family) for whom the corporation was created as a foreign "incorporated pocketbook." However, the set-up is not always so simple and in some instances the tax avoidance plan may involve a division of the stock of the foreign company among controlled domestic corporations, partnerships, estates, and trusts. For that reason, and since all such controlled domestic interests are within the jurisdiction of the United States, section 337 applies not only to citizens or residents of the United States who are shareholders in the foreign personal holding company but also to any domestic corporation, partnership, estate or trust which may be a shareholder therein. The revenue laws define "domestic corporation" and "domestic partnership" but do not define a domestic estate or trust. Accordingly, section 337 contains a further specification to the effect that estates and trusts which make returns only of income from sources within the United States are not counted as United States shareholders.

Subsection (b): The particular United States shareholders to be taxed upon the undistributed Supplement P net income of the foreign personal holding company are fixed by the stockholdings as of the last day of the company's taxable year on which more than 50 percent in value of its outstanding stock was owned by a United States group of five or less individuals. While in some cases the "United States group" may be identical with the "United States shareholders" the two terms are nevertheless distinct. For example, a domestic corporation which owns stock in the foreign company is a United States shareholder for purposes of section 337 but is not a member of the United States group since, under section 333 (a) (1), the stock it owns in the foreign company is considered as being owned proportionately by its shareholders for the purpose of determining whether the foreign company constitutes a foreign personal holding company.

The undistributed supplement P net income of the foreign personal holding company for its taxable year is taxed to the United States shareholders in the same ratio that the portion of the taxable year up to and including the last day on which the United States group existed bears to the entire taxable year. Thus, if the United States group existed on the last day of the taxable year, the United States shareholders would return their pro-rata shares of the undistributed supplement P net income for the entire taxable year. But if the last day on which the United States group existed was on September 30, the United States shareholders would, if the taxable year was a calendar year, return only nine-twelfths of the undistributed supplement P net

income for the entire taxable year. It will be observed that in the last case the calculation is based upon the undistributed supplement P net income for the entire taxable year and not merely upon the income received by the foreign company prior to September 30. By this rule, all dividend distributions made by the foreign company are taken into account regardless of the day within the taxable year on which the last United States group existed. If, in the last case, the current earnings had all been distributed after September 30, there would have been no undistributed supplement P net income to be returned by the United States shareholders who owned stock in the foreign company on September 30.

The pro-rata shares of the undistributed supplement P net income to be returned by the United States shareholders are treated as a dividend paid by the foreign company and received by the United States shareholders on the last day of the foreign company's taxable year on which the United States group existed. The respective amount to be returned by each United States shareholder depends not only upon the number of shares of stock owned by him but also upon the relative rights of the several classes of shareholders, if the foreign company has more than one class of stock outstanding. Thus, if the foreign company has both common and preferred stock outstanding and the preferred stock, whether cumulative or noncumulative, ranks ahead of the common stock with respect to dividend distributions, the assumed distribution of the undistributed supplement P net income will first be applied to the preferred shareholders according to their relative and respective interests, before being allocated to the common shareholders. Section 337 (b) expressly provides that the amounts returned by the United States shareholders as their pro-rata shares of the undistributed supplement P net income shall be treated as a dividend paid by the foreign company and a dividend received by the shareholders in order that such amounts will be given the same full force and effect as though the assumed distribution had actually been made by the foreign company.

In its application, section 337 reaches all United States shareholders who own stock in the foreign personal holding company on the specified day. The section may, therefore, reach individuals having only a minority interest in the foreign company. However, that is not considered very likely to happen. In the ordinary course of events, strangers do not hold stock in a family-owned "incorporated pocketbook", whether incorporated under foreign or domestic law. Moreover, the definition placed upon the term "foreign personal holding company" should exclude foreign corporations whose securities are listed on any exchange so that Americans generally might purchase such securities as investments. If any individual is a minority shareholder of a foreign personal holding company, it is more than likely that such individual is a member of, or is in some way connected with, the family owning and controlling the foreign company. If by chance an individual should be a minority shareholder in a foreign corporation under such circumstances that he would not be aware of the company's classification as a foreign personal holding company, he would not be subjected to any penalties for failing to comply with section 337. At most, his failure would stay the tolling of the statutory period of limitations upon assessment and collection for a period of 7 years and he would, within such period, be subjected to a deficiency assessment when the fact became known.

Section 337 (c) proposes to allow the United States shareholder a credit against his normal tax (and in the case of a corporate shareholder, credit against the surtax on undistributed profits) for his proportionate share of the interest received by the foreign company on obligations of the United States of the classes specified in section 25 (a) (1) or (2). This rule applies only where the foreign corporation in which the United States shareholder owns stock in fact received such interest and not where such interest is included in the gross income of the foreign company by reason of its ownership of stock in another foreign personal holding company. Thus if the United States shareholders owned the stock of corporation A, a foreign personal holding company, and the latter owned the stock of corporation B, also a foreign personal holding company, and both foreign companies received interest on United States obligations, the United States shareholders would be entitled to a credit only for the interest actually received by corporation A and not for any of the interest received by corporation B which might be included in corporation A's gross income either as a dividend from corporation B or as a constructive dividend from corporation B under section 334 (b).

Section 337 (d) requires that each United States shareholder who includes in his gross income his pro-rata share of the undistributed supplement P net income of a foreign personal holding company, shall, if he owns 5 percent or more in value of the outstanding stock, set forth in his return in complete detail a statement of the gross income, deductions and credits, supplement P net income and undistributed supplement P net income of the foreign company for its taxable year. This requirement is necessary since a return may not be filed by the foreign company from which such information may otherwise be procured.

Section 337 (e): In order to avoid the possibility that amounts of undistributed supplement P net income of foreign personal holding companies, which are returned by United States shareholders as constructive dividends, might be taxed again when later actually distributed, it has been provided that the entire undistributed supplement P net income for a taxable year, with respect to which such persons are required to include in gross income their distributive shares, shall be considered as a contribution to capital of the foreign personal holding company. A subsequent distribution, if made out of such capital, would not be paid out of earnings and profits for the taxable year and would not constitute a dividend under section 115 of the Revenue Act of 1936. Through the application of existing law the plan, however, would operate to require the company to distribute all its accumulated earnings and profits before a tax-free distribution could be made. The application of the rule is illustrated by the following example: X, a foreign personal holding company, is owned 75 percent by A, a citizen of the United States, and 25 percent by B, a nonresident alien. For the calendar year 1937 X has an undistributed supplement P net income of $100. A would be required to report $75. X would treat $100 as a contribution to capital. If for the calendar year 1938 X had no income and no accumulated earnings and profits, but distributed $100, the dividend would be tax free in the hands of both A and B. If, however, X had accumulated earnings and profits of $100 at the beginning of 1937, the facts otherwise being the same, the distributions in 1938 would be taxable to A and the

taxability of B would depend upon the application of section 119 (a) (2) (B) of the Revenue Act of 1936.

Section 337 (f): This is a corollary to the proposed rule in section 337 (e). It is provided that the amount of the undistributed supplement P net income required to be included in the gross income of United States shareholders should be added to the basis of their shares and be treated as having been remitted by the shareholder as a contribution to the capital of the company. This rule, however, only applies to the extent the amount is included in the gross income of the shareholder increased or decreased by any adjustment in the last determination of the shareholder's tax liability, made before the expiration of 7 years after the date prescribed by law for filing the return.

The application of the rule is illustrated as follows: In the example given under (e) assume the basis of A's stock to be $300. If A takes up $75 as a constructive dividend in 1937 the basis of his stock would be $375. When the $75 is distributed tax-free, A's basis assuming no other changes, would again be $300. If A failed to include the $75 as required by law and his failure was not discovered until after the 7-year statute of limitations had expired, the application of the rule would not increase the basis of A's stock. The subsequent tax-free distribution of $75 would reduce his basis to $225 thus tending to compensate for his failure to report the amount of $75 in his gross income. If the Commissioner should readjust the undistributed supplement P net income of the company within the statutory period thus increasing or decreasing the amount A should have reported, proper adjustment would be made. Moreover, this rule as to adjustment of the shareholder's basis applies even though the shareholder has sold his stock and reported a capital gain in gross income in a taxable year prior to the year in which he is required to include in gross income his distributive share of the undistributed supplement P net income of the company. In some cases such adjustment may entitle the shareholder to a refund with respect to such prior year.

NEW SECTIONS 338, 339, 340, AND 341, 1936 ACT—INFORMATION RETURNS

In order adequately to enforce the provisions of supplement P added to the Revenue Act of 1936 by title II, it is necessary that the Treasury have information as to the existence of foreign personal holding companies, who their United States shareholders are, and the income of, and distributions by, foreign personal holding companies. Since the United States may have no effective jurisdiction over the corporations themselves, the only persons from whom such information can usually be obtained are the American citizens or residents who are interested in them.

Section 338 of the proposed supplement P requires officers and directors of foreign corporations which were foreign personal holding companies for the preceding taxable year to file monthly returns and annual returns. The monthly returns must be filed with the Commissioner on the fifteenth day of the month covering the preceding calendar month and must show the name and address of each shareholder, the class and number of shares held by each, the names and addresses of holders of securities convertible into stock, the changes in ownership during the period, and such other information as may

be prescribed to carry out the Act. The Commissioner may permit the filing of returns covering a longer period in lieu of monthly returns.

Similarly, annual returns are required of officers and directors of such foreign corporations. These returns must set forth in complete detail the gross income, deductions and credits, net income, supplement P net income, and undistributed supplement P net income of the foreign personal holding company for the year. If the required number of monthly returns with respect to stock ownership has not been filed, the officers and directors must file an annual return showing, with respect to the year, the same information as is required under the monthly returns provisions.

Section 339 requires returns by United States shareholders by or for whom more than 50 percent or more in value of stock (including stock held by the family) is owned if the foreign corporation was a foreign personal holding company for the preceding taxable year. The information required, the power of the Commissioner to prescribe a longer period than a month, and the requirement of an annual report, if all reports for the shorter period are not filed, are the same as in section 338.

Section 340 provides that under regulations prescribed by the Commissioner with the approval of the Secretary any attorney, accountant, fiduciary, bank, trust company, financial institution, or other person who on or after the date of the enactment of this bill aids, assists, counsels, or advises in, or with respect to, the formation, organization, or reorganization of any foreign corporation shall, within 30 days after giving such aid, assistance, counsel, or advice, file with the Commissioner of Internal Revenue a return. The section also requires such persons who since 1933 and prior to 90 days after the date of the enactment of this bill have aided, assisted, counseled, or advised in the formation, organization, or reorganization of any foreign corporation within 90 days after the date of the enactment of this bill to file a return with the Commissioner of Internal Revenue. Returns required by the section must be under oath and must give such information in the possession, knowledge, or control of such person as the Commissioner with the approval of the Secretary prescribes by regulations as necessary for carrying out the provisions of the Revenue Act of 1936. Nothing in this section is to be construed to require the divulging of privileged communications between attorney and client.

Section 341 provides a criminal penalty for the willful failure to comply with section 338, 339, or 340, such penalty to be in lieu of the penalties provided in section 145 (a) of the Revenue Act of 1936 for such offense.

SECTION 202 OF THE BILL—EFFECTIVE DATES

Section 202 of the bill deals with the effective date of the provisions relating to foreign personal holding companies. It provides that the provisions of supplement P, added to the Revenue Act of 1936 by section 201 of the bill, shall not apply to a taxable year ending on or before the date of the enactment of this bill into law, and that no foreign corporation shall be considered a foreign personal holding company unless, after the date of the enactment of this act, more than 50 percent in value of its outstanding stock is owned, directly or

indirectly, by or for five or less individuals who are citizens or residents of the United States.

The section also allows a period of grace for filing the first information returns which are required by sections 338 and 339 of supplement P to be filed by officers and directors and principal United States shareholders of foreign personal holding companies.

SECTION 203 OF THE BILL—ADJUSTED BASIS OF STOCK OF FOREIGN PERSONAL HOLDING COMPANY

This section makes the necessary substantive change in section 113 (b) of the Revenue Act of 1936 (which relates to adjusted basis for determining gain or loss on the sale or exchange of property) to complement the provision of section 337 (f) of supplement P which provides that the basis of stock owned by United States shareholders is adjusted on account of amounts included in their gross income under supplement P. This amendment provides that the provision stated in section 337 (f) is a rule of section 113 (b).

SECTION 204 OF THE BILL—BASIS OF STOCK IN FOREIGN PERSONAL HOLDING COMPANY ACQUIRED BY DECEDENT

The general rule governing the basis of property acquired from a deceased person by his estate or by bequest, devise, or inheritance is stated in section 113 (a) (5) of the Revenue Act of 1936, viz, the fair market value of such property at the time of such acquisition. Your committee believes that an exception to this general rule should be created, in the case of a decedent dying after the date of enactment of the Revenue Act of 1937, where the property so acquired consists of stock or securities of a foreign corporation which for its taxable year next preceding the date of the decedent's death was a foreign personal holding company, i. e., a corporation which for such year satisfies the gross income requirement of section 331 (a) (1), and with respect to which a United States group (as defined in sec. 331 (a) (2)) existed at any time during such year. It is the view of the committee that the proper rule as to basis to be applied in such cases should be the fair market value of such property at "the time of such acquisition or the basis in the hands of the decedent, whichever is lower." Section 204 of the bill would establish this rule.

The committee feels that this more severe rule is justified by the character of the corporations to whose stock and securities its application is limited. Such foreign personal-holding companies are, with few exceptions, it is believed, formed or availed of by their owners to evade or avoid the payment of their just share of Federal income taxes by the accumulation of income abroad. Sound fiscal policy demands that all possible lawful means be invoked to protect the integrity of the revenues from the destructive effects of widespread resort to this type of tax-dodging device. The rule contained in section 204 is therefore thought to be justified by the same sort of considerations as the established principle applicable to transfers by gift, contained in section 113 (a) (2) of the Revenue Act of 1936.

Section 204 is also intended to complement and support section 205 of the bill relating to liquidation of foreign personal holding companies. Together they should operate to exert effective pressure upon the American owners of these foreign companies to dissolve them with a minimum of delay.

SECTION 205 OF THE BILL—LIQUIDATION OF FOREIGN PERSONAL HOLDING COMPANIES

Section 115 (c) of the Revenue Act of 1934 excepted from the benefits of section 117 (a), relating to gains on the sale or exchange of capital assets, gains realized by stockholders on the partial or complete liquidation of a corporation. Hence, 100 percent of the gains on such liquidations were required to be taken into account in computing net income, without regard to the length of time a shareholder had held his stock. This severe rule was relaxed in the Revenue Act of 1936 by an amendment to section 115 (c), which extended section 117 (a) to gains realized in the case of distributions in complete liquidation, "complete liquidation" being defined for the purposes of such amendment to include "any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona-fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding 2 years from the close of the taxable year during which is made the first of the series of distributions under the plan." One of the considerations which motivated the adoption of this amendment was the desire to encourage and facilitate the dissolution of personal holding companies formed in foreign countries by American citizens and residents in prior years.

Your committee believe that the time has arrived to withdraw altogether from the stockholders of such companies the benefits of section 117 (a), unless they are liquidated within a limited time after the date of the enactment of this bill. That is the purpose and effect of section 205 of the bill. It would apply to any foreign corporation which with respect to any taxable year beginning on or before, and ending after, the date of the enactment of the Revenue Act of 1937, was a foreign personal holding company, and with respect to which a United States group (as defined in sec. 331 (a) (2)) existed after the date of such enactment. In order for the shareholders of any such corporation to derive any benefit from section 117 (a), it would be necessary that the liquidation be completed before January 1, 1938. Since your committee recognize that this limited period may not be adequate in certain cases for the completion of a liquidation already started or promptly begun, further provision has been made under which the Commissioner is authorized to extend the time for the completion of the liquidation for such period as he may find reasonable, but not later than June 30, 1938, if it is established to his satisfaction by evidence submitted before January 1, 1938, that due to the laws of the foreign country in which the corporation is incorporated, or for other reason, it is or will be impossible to complete the liquidation before that date.

This withdrawal of the privileges created by the amendment to section 115 (c) in the 1936 act will have no application to or effect upon bona fide operating companies incorporated by Americans in foreign countries to carry on legitimate commercial enterprises nor upon foreign investment companies whose stock is widely held. Rather, it will operate only against a class of companies formed or used primarily to evade or avoid Federal taxes. Their rapid dissolution is highly desirable as a matter of sound fiscal policy. Your committee believe section 205 will create an effective inducement to

prompt liquidation in the case of many of the companies to which it applies.

SECTION 206 OF THE BILL—STATUTE OF LIMITATIONS

Section 206 (a) of the bill provides for a 7-year statute of limitations in cases where the taxpayer omits from his gross income the amount of his distributive share of the undistributed income of a foreign personal holding company. In view of the difficulty which the Government has in obtaining information with respect to foreign corporations formed or used for tax avoidance and the possibilities of concealment of ownership by shareholders, it is believed that a period longer than the usual period for assessment and collection without assessment of the tax is necessary. Subsections (b) and (c) make necessary technical and clerical amendments to carry out the policy of subsection (a).

SECTION 207 OF THE BILL—MINOR AMENDMENTS

Section 4 of title I of the Revenue Act of 1936 provides that the general provisions of title I apply to special classes of taxpayers subject to the exceptions and additional provisions contained in the supplement applicable to such taxpayers. Section 207 (a) makes this provision apply to supplement P added by title II of the bill. The remaining subsections of section 207 make necessary cross references.

TITLE III—DISALLOWED DEDUCTIONS

SECTION 301 OF THE BILL—DISALLOWED DEDUCTIONS

Losses from sales or exchanges

Under existing law, section 24 (a) (6) of the Revenue Act of 1936, losses are specifically denied in the case of sales or exchange of property between members of a family or between a shareholder and a corporation in which such shareholder and his immediate family owns more than 50 percent in value of the outstanding stock. This provision of existing law is not exclusive and the Government may still deny losses in the case of sales or exchanges not specifically covered thereby (for instance, between uncle and nephew) if such sales or exchanges are not bona fide. However, because the evidence necessary to establish the fact that a sale or exchange was not made in good faith is almost wholly within the knowledge of the person claiming the deduction, the Government has encountered considerable difficulty in sustaining the disallowance of the deduction in a great many cases. Moreover, the specific provisions of section 24 (a) (6) of existing law have proved inadequate to meet many situations of this type. Accordingly, your committee proposes the amendment of this section to provide certain additional restrictions on deductions of this character. However, as in the case of the provisions of existing law, it is not intended by this amendment to imply any legislative sanction of claiming deductions for losses on sales or exchanges in cases not covered thereby, where the transaction lacks the elements of good faith or finality, generally characterizing sales and exchanges of property.

Section 301 adds to existing law provisions which specifically deny losses between—

(1) Two corporations if more than 50 percent in value of the outstanding stock in both is owned, directly or indirectly, by the same individual, and if either one of the corporations was a personal holding company for the preceding taxable year;

(2) An individual and a corporation in which such individual, together with a partner, owns more than 50 percent in value of the outstanding stock;

(3) An individual and a fiduciary of any trust of which the individual is a grantor;

(4) A fiduciary of one trust and a fiduciary of another trust, if any grantor of one of the trusts is also a grantor of the other; and

(5) A fiduciary of a trust and any beneficiary of such trust.

The amendments made by section 301 further strengthen the existing law by applying, for the purpose of determining stock ownership in a corporation, substantially the same rules as used in determining the stock ownership of a personal holding company. The present law and the proposed bill provide that an individual shall be considered as owning the stock held by the members of his family. (This rule, carried into the section as rewritten by the bill, does not, of course, operate to disallow a loss on a sale by a wife to her brother-in-law of stock in a corporation. Although for the purpose of applying paragraphs (1) (B) and (C) the stock owned by the wife may be considered as owned by the husband, it is the wife and not the husband who made the sale and sustained the loss.) By the proposed amendments, the stock ownership rules are enlarged so that—

(1) Stock held by a corporation, partnership, estate, or trust is considered to be owned proportionately by its shareholders, partners, or beneficiaries; and

(2) Stock held by an individual's partner is considered to be owned by such individual if such individual also owns stock in the corporation.

In applying the stock-ownership rules, stock constructively owned by an individual as the shareholder, partner, or beneficiary of the corporation, partnership, or trust, or estate, which holds the stock is considered to be actually owned by such individual for the purpose of making another the constructive owner of such stock. Thus, if all the stock of corporation X is held by corporation Y, and all the stock of corporation X is owned in equal proportion by three brothers, A, B, and C, no loss would be allowable on a sale or exchange of property between A, or B, or C and corporation X or corporation Y. With respect to corporation Y, each brother would be considered as owning the stock actually owned by his brothers and, therefore, each would be a constructive owner of all the stock of corporation Y. With respect to corporation X, its stock, although owned by corporation Y, would be considered as constructively owned by A, B, and C in equal proportions, and such constructive ownership by A, B, and C would be considered as actual ownership for the purpose of making A, B, or C the constructive owner of all the stock of corporation X.

However, stock constructively owned by an individual through the application of the rules applying to family relationships or a partnership relation is not considered to be actually owned by the constructive owner so as to make another the constructive owner of the stock. Thus, if all the stock of corporation X was owned 5 percent by A,

20 percent by B, his brother, 50 percent by W, his wife, and 25 percent by P, his partner, no loss would be allowable on a sale or exchange of property between A or W and corporation X. A would constructively own the stock of his brother, his wife, and his partner and so would constructively own all the stock of corporation X. W would constructively own the 5 percent actually owned by her husband A but not the 20 percent and 25 percent constructively owned by A as B's brother and P's partner, respectively. Accordingly, W would own constructively 55 percent of the stock or more than 50 percent and her loss would not be allowable. Similarly, on the application of the same rule, B and P would be considered as owning constructively only the 5 percent actually owned by A and so would be constructive owners of 25 percent and 30 percent, respectively, or, in each case, less than 50 percent.

Additional illustrations of the application and effect of the stock ownership rules are set out in the following table:

Assuming that—

A owns 45 percent of the stock of corporation X (which is a personal holding company) and A also owns 10 percent of the stock of corporation Y.

B, who is A's brother, owns 5 percent of the stock of corporation X and 41 percent of the stock of corporation Y.

P, who is A's partner, owns 5 percent of the stock of corporation X and no stock of corporation Y.

W, who is A's wife, owns 40 percent of the stock of corporation Z, a personal holding company.

Corporation X owns 60 percent of the stock of corporation Z.

Losses would not be allowable between—

PARTIES	REASON
X corporation and Y corporation	A owns more than 50 percent in value of the outstanding stock of both corporations and one of the corporations is a personal holding company.
X corporation and Z corporation	
Y corporation and Z corporation	
A and X corporation	The individuals own more than 50 percent in value of the outstanding stock.
A and Y corporation	
A and Z corporation	
B and Y corporation	
W and Z corporation	
A and B	Family relationship of the individuals.
A and W	

The following transactions would not be affected and any losses, otherwise allowable, would be allowed:

Transactions between:

X corporation or Z corporation and B.
X corporation or Y corporation or Z corporation and P.
X corporation or Y corporation and W.
B and P or W.
P and A or B or W.
W and B or P.

It will be observed from the foregoing table that the amendments made by section 301 (a) and (b) do not reach all possible situations in which, due to family relationships or friendly control, artificial losses might be created for tax purposes. It should also be noted that in the case of the family rule under the amendments as well as under

existing law, it is not necessary for the individual to own stock himself in the corporation which is the party to a sale or exchange between him and the corporation for the loss to be disallowed. For instance, losses resulting from sales or exchanges between a husband and his wife's corporation are not deductible, regardless of whether or not the husband owns any stock in such corporation.

SECTION 301 OF THE BILL—UNPAID EXPENSES AND INTEREST

Section 301 also adds to section 24 of the 1936 act a subsection (c) which denies deductions for unpaid expenses and interest in certain cases. Under existing law, some individuals have attempted to take advantage of the difference in operation between different accounting methods of reporting income to obtain artificial deductions for interest and business expenses. For example, it was found that an individual on the accrual basis became indebted either to an individual with whom he enjoyed a special relationship, such as a member of his family, or to a corporation which he controlled, and his creditor reported income on the cash basis. Thereafter as interest became due on the indebtedness, the debtor on the accrual basis reported the interest as a deduction for income-tax purposes, but he did not make any actual payment to his creditor. Since the creditor was on a cash basis, he reported no income and thus the sum involved escaped income tax altogether, for usually in these cases if the payment were finally made it was done at a time when the creditor had offsetting losses. The use of this device as a practical matter is restricted to situations where the parties occupy special relationships to each other because an ordinary bona-fide creditor would not permit his debtor to engage in such a practice.

Your committee recommends that section 24 of the Revenue Act of 1936 be amended by adding a new subsection under which it is provided that where the creditor, by reason of his method of accounting, is not required to include in his gross income the amount of the expenses or the interest until it is paid, no deduction shall be allowed to the debtor under section 23 (a) (for expenses) or section 23 (b) (for interest) for sums not paid by the debtor during his taxable year or within 2½ months after the close of such taxable year. This provision is limited in its application to cases in which both the taxpayer and the person to whom the payment is to be made are, at the close of the year of the taxpayer or at any time within 2½ months thereafter, persons between whom losses would be allowed under section 24 (b).

SECTION 302 OF THE BILL—EFFECTIVE DATE

This section provides that the amendments made by section 301 shall apply only with respect to taxable years beginning after December 31, 1936.

TITLE IV—TRUSTS

SECTION 401 OF THE BILL—DENIAL OF PERSONAL EXEMPTION TO TRUSTS

This section amends section 163 (a) of the Revenue Act of 1936 by eliminating the $1,000 exemption now granted to all trusts. This will not affect trusts which distribute their income, since such trusts are not taxable and the beneficiaries have the right to a personal exemption

under existing law but will prevent trusts to accumulate from escaping tax entirely. For example, if an individual forms 50 trusts, each of which has an income of not more than $1,000 a year to be accumulated, under existing law no income tax is paid. Under your committee's proposal, the entire net income of each such trust would be subject to some tax. Further consideration and study will be given to the general problem of the proper treatment for tax purposes of multiple trusts to accumulate income.

SECTION 402 OF THE BILL—FIDUCIARY RETURNS

This section amends section 142 (a) of the Revenue Act of 1936 relating to fiduciary returns. In addition to the returns required from fiduciaries of trusts under existing law, the section requires the fiduciary to file a return in the case of any trust having a net income, regardless of amount. A return is also required from the fiduciary of a trust where the distributions under the terms of the trust are discretionary or based on a contingency, even though the trust may have no net income because the fiduciary has made complete distribution.

In any case where the distribution is a charge upon the corpus of the trust and, therefore, not taxable in the hands of the beneficiary, the fiduciary will, in most cases, be required to file a return under this section because as such distribution is not deductible in computing the income of the trust, the trust may have a net income.

SECTION 403 OF THE BILL—EFFECTIVE DATES

This section provides that the amendments made by title IV should be effective only with respect to taxable years beginning after December 31, 1936.

TITLE V—NONRESIDENT ALIEN INDIVIDUALS

SECTION 501 OF THE BILL

Section 211 (a) of the Revenue Act of 1936 imposes on nonresident alien individuals not engaged in trade or business within the United States and not having an office or place of business therein, a flat rate of tax of 10 percent on income from interest, dividends, rents, salaries, annuities, and similar fixed and determinable annual or periodical income (including royalties) received from United States sources. This tax is in the usual case collected at the source by means of withholding, and has worked well both from an administrative and revenue standpoint. While the additional revenue derived over that produced under prior revenue acts is estimated to be not less than $15,000,000 per annum, it appears that certain wealthy nonresident aliens have had their Federal income taxes substantially reduced by this new system. In fact, it has permitted certain former citizens of the United States now citizens of other countries, but who derive a large amount of income from sources within the United States either directly or through an American trust, to pay substantially less Federal income tax than they paid under prior revenue acts.

If these individuals were subject to both normal and surtaxes the effective rate of tax on their income from sources within the United

States would be much higher than the 10-percent rate applicable to such income under existing law. To remedy this situation it is proposed that section 211 (a) of existing law be amended so that it will not apply to any nonresident alien individual if the aggregate amount received during the taxable year from the sources specified in section 211 (a) is more than $21,600. This amount is the approximate point at which the effective rate (normal tax-plus surtaxes) becomes 10 percent. It is also proposed that if the aggregate amount received from the sources specified in section 211 (a) exceeds $21,600 such alien individual be subject to normal and surtaxes on such income with the allowance of the credits and certain deductions provided in supplement H of existing law. In view of the fact that gains from the sale or exchange of capital assets are not taxable to such aliens, losses from such transactions are not allowed. For this reason the deductions (other than the 15-percent deduction for contributions to United States charities provided in section 213 (c) of existing law) should be allowed only to the extent they are properly allocable to the gross income from United States sources which is subject to the tax. A further limitation is imposed that the tax in no case shall be less than 10 percent of the gross income from the sources specified in section 211 (a). This is necessary to prevent the payment of less tax (due to credits and deductions) than is paid under existing law.

In view of the fact that the approximate point at which the effective rate (normal tax-plus surtaxes) becomes 10 percent, is $21,600, it is not believed that the new plan will unduly increase the tax on nonresident aliens whose net income is just sufficient to take them out of the old rule and subject them to the new rule. It is believed that the cases are too few in number and the increase in tax is too small to warrant any special treatment for such cases.

There will be withheld from the amounts receivable by a nonresident alien taxed under the new provisions the amounts required to be withheld under section 143 of the present law. Such individuals will be required to file annual returns with the collector at Baltimore, Md. They will, however, be entitled, in computing their tax, to a credit in their returns for the amount which has been so withheld at the source.

Section 211 (a) of the Revenue Act of 1936 provided that the rate of 10 percent "shall be reduced in the case of a resident of a contiguous country, to such rate (not less than 5 percent) as may be provided by treaty with such country." In order to preserve the benefit of any treaty with such a country that may have been ratified prior to the date of the enactment of the proposed act it is provided in section 501 (c) of the bill that the amendments to section 211 shall not apply to the residents of such a country so long as such a treaty is in effect.

The amendments made by the title apply only to taxable years beginning after December 31, 1936.

Title VI—Miscellaneous

SECTION 601 OF THE BILL—CORPORATIONS EXCEPTED FROM SECTION 102

This section adds to section 102 of the present law, which imposes a surtax on corporations improperly accumulating surplus, a new subsection which excludes certain domestic and foreign corporations from the operation of that section. The present law and the amendments

proposed have as a basic principle that a corporation is not improperly accumulating surplus if the amount accumulated is subject to substantially the same taxes as if it were distributed. Under the present law corporations subject to title IA of the present law are excluded from section 102. Section 601 carries out a corresponding policy with respect to a corporation subject to new title IA and a foreign corporation whose United States shareholders are obliged to include its undistributed income in their return. The effect of the amendment is to exclude from section 102 domestic and foreign personal holding companies for taxable years for which they are subject to title IA before or after its amendment by the bill or to the provisions of supplement P added by the bill.

SECTION 602 OF THE BILL—MUTUAL INVESTMENT COMPANIES

This section excludes from the special treatment accorded mutual investment companies, domestic and foreign personal holding companies for taxable years for which they are subject to title IA before or after its amendment by the bill or to the provisions of supplement P added by the bill.

SECTION 603 OF THE BILL—SEPARABILITY CLAUSE

This section contains the separability clause.

CONCLUSION

Your committee has pointed out that the major purpose of this bill is to close loopholes in the revenue laws of which numerous taxpayers have availed themselves, often by means of ingenious and complex devices, to escape the share of the burdens of taxation the Congress has intended that they should bear. The committee believes the proposed legislation is adequate for these purposes but also recognizes the difficulty of framing a tax law which is wholly proof against all the devices and schemes which legal ingenuity may evolve. Should time reveal that new stratagems are being devised to thwart the spirit and intent of the corrective legislation which the Congress may enact at this time, it is the purpose of your committee to frame such further legislation as may be necessary to checkmate them and, to whatever extent may be consistent with justice and sound policy, to recommend that the legislation be made retroactive. It is believed that such measures of this kind as may be required to protect the integrity of the revenue laws are well within the scope of constitutional power and will be sustained by the courts.

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