TRUST AND PARTNERSHIP INCOME TAX REVISION ACT OF 1960

1432-3

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-SIXTH CONGRESS

SECOND SESSION

ON

H.R. 9662

AN ACT TO MAKE TECHNICAL REVISIONS IN THE INCOME TAX PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954 RELATING TO ESTATES, TRUSTS, PARTNERS, AND PARTNERSHIPS, AND FOR OTHER PURPOSES

APRIL 20, 21, AND 22, 1960

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TRUST AND PARTNERSHIP INCOME TAX REVISION ACT OF 1960

WEDNESDAY, APRIL 20, 1960

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2221, New Senate Office Building, Senator J. Allen Frear, Jr., presiding.

Present: Senators Frear, Talmadge, Williams, Bennett, and Curtis.

Also present: Elizabeth B. Springer, chief clerk; and Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation.

Senator FREAR. The committee will come to order.

The committee has been called to hear testimony on the Trust and Partnership Income Tax Revision Act of 1960, H.R. 9662. I submit for the record a copy of the bill and summaries explaining the provisions in title I, relating to the estate and trust tax provisions, and title II relating to partners and partnerships.

(The bill and explanations follow:)

[H.R. 9662, 86th Cong., 2d sess.]

AN ACT To make technical revisions in the income tax provisions of the Internal Revenue Code of 1954 relating to estates, trusts, partners, and partnerships, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Trust and Partnership Income Tax Revision Act of 1960".

(b) AMENDMENT OF 1954 CODE.—Whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

TITLE I—ESTATES AND TRUSTS

SEC. 101. IMPOSITION OF TAX—AMENDMENTS OF SECTION 641.

(a) APPLICATION OF TAX.—Section 641 is amended by adding at the end thereof the following new subsection:

"(c) LEGAL LIFE ESTATES AND OTHER TERMINABLE LEGAL INTERESTS.—If—

"(1) any person owns a legal interest in property which may terminate on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, and

"(2) at any time during any calendar year there is gross income attributable to such property—

"(A) which (but for this subsection) would not be currently includible in the gross income of any person because such person is not then ascertainable or for any other reason, but

"(B) which would be currently includible in the gross income of a trust with respect to such property if such a trust existed (determined without regard to subpart E),

then, for purposes of this subchapter and subtitle F, a trust shall be deemed to exist for such calendar year with respect to all gross income described in paragraph (2) attributable to such property, and the person (or persons) described in paragraph (1) shall be deemed to be a fiduciary of such trust."

(b) TECHNICAL AMENDMENT.—Section 641(a)(2) is amended by striking out ", and income collected by a guardian of an infant which is to be held or distributed as the court may direct".

SEC. 102. SPECIAL RULES FOR CREDITS AND DEDUCTIONS—AMENDMENTS OF SECTION 642.

(a) DIVIDENDS RECEIVED BY INDIVIDUALS.—Section 642(a)(3) is amended by striking out the second sentence and inserting in lieu thereof the following new sentences: "An estate or trust shall be entitled to the exclusion of dividends received under section 116(a) (determined without regard to the second sentence thereof), but only in respect of so much of such dividends as is not properly allocable to any beneficiary under section 652 or 662. For purposes of this paragraph, there shall be taken into account only those dividends of a kind for which a credit is allowable under section 34(a) or an exclusion is permitted under section 116(a), as the case may be."

(b) DEDUCTIONS FOR CHARITABLE, ETC., CONTRIBUTIONS.—Section 642(c) is amended to read as follows:

"(c) DEDUCTION FOR CHARITABLE, ETC., CONTRIBUTIONS.—In the case of an estate or trust, the deduction allowed by section 170 (relating to deduction for charitable, etc., contributions and gifts) shall not be allowed, but the estate or trust shall be allowed a deduction for such contributions and gifts to the extent provided in section 661."

(c) DEDUCTION FOR DEPRECIATION AND DEPLETION.—Section 642(e) is amended by striking out the word "allowable" and inserting in lieu thereof "apportioned".

(d) UNUSED LOSS CARRYOVERS AND EXCESS DEDUCTIONS ON TERMINATION AVAILABLE TO BENEFICIARIES.—Section 642(h) is amended to read as follows:

"(h) UNUSED LOSS CARRYOVERS AND EXCESS DEDUCTIONS ON TERMINATION AVAILABLE TO BENEFICIARIES.—If, on the termination of an estate or trust, the estate or trust has—

"(1) a net operating loss carryover under section 172 or a capital loss carryover under section 1212, or

"(2) for the last taxable year of the estate or trust, deductions (other than the deduction for personal exemption allowed under subsection (b)) in excess of gross income for such year,

then, under regulations prescribed by the Secretary or his delegate, such carryover or such excess shall be allowed as a deduction to the beneficiary succeeding to the property of the estate or trust (and not to the estate or trust). For purposes of this subsection, separate and independent shares of different beneficiaries in a single trust or estate shall be treated as separate trusts or estates."

(e) DEDUCTION FOR ESTATE TAX ON INCOME IN RESPECT OF A DECEDENT.—Section 642 is amended by redesignating subsection (i) and subsection (j), and by inserting after subsection (h) the following new subsection:

"(i) DEDUCTION FOR ESTATE TAX ON INCOME IN RESPECCT OF A DECEDENT.—An estate or trust shall be allowed the deduction provided by section 691(c) (relating to the deduction allowed for estate tax on income in respect of a decedent) only in respect of so much of the income in respect of a decedent as is not properly allocable to a beneficiary under section 652 or section 662."

SEC. 103. DEFINITIONS—AMENDMENTS OF SECTION 643.

(a) DEDUCTION FOR PERSONAL EXEMPTION AND FOR ESTATE TAX.—Section 643(a)(2) is amended to read as follows:

"(2) DEDUCTION FOR PERSONAL EXEMPTION AND FOR ESTATE TAX.—No deduction shall be taken under section 642(b) (relating to deduction for personal exemptions) or section 691(c) (relating to deduction for estate tax attributable to income in respect of a decedent)."

(b) CAPITAL GAINS AND LOSSES AND CORPUS ITEMS OF DEDUCTIONS.—Section 643(a)(3) is amended to read as follows:

"(3) CAPITAL GAINS AND LOSSES AND CORPUS ITEMS OF DEDUCTIONS.—

"(A) CAPITAL GAINS AND LOSSES.—Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (i) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (ii) permanently set aside or to be used for purposes specified in section 661(a)(4). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account.

"(B) RULE FOR DETERMINING WHEN CAPITAL GAINS ARE PAID, CREDITED, OR REQUIRED TO BE DISTRIBUTED.—Capital gains shall not be considered paid, credited, or required to be distributed to a beneficiary within the meaning of subparagraph (A) except to the extent that—

"(i) they are required to be distributed during the taxable year under the provisions of the governing instrument or applicable local law;

"(ii) the books or records of the estate or trust or notice to the beneficiary shows an intention properly to pay or credit such amounts to the beneficiary during the taxable year;

"(iii) the fiduciary follows the regular practice of distributing all capital gains;

"(iv) capital gains are received by the estate or trust in its year of termination; or

"(v) capital gains are received by the estate or trust in the year of termination of a separate and independent share of the estate or trust, but only to the extent attributable to such separate share.

"(C) CORPUS ITEMS OF DEDUCTION.—Corpus deductions shall be excluded to the extent that—

"(i) the gross income excluded in computing distributable net income, exceeds

"(ii) the deductions which (without regard to this subparagraph) are excluded in computing distributable net income.

For purposes of this subparagraph, the term 'corpus deductions' means the deductions which (but for this subparagraph) would be taken into account in computing distributable net income and which are either chargeable to undistributed corpus under the provisions of the governing instrument and applicable local law or which are charged to undistributed corpus as the result of the exercise of discretion by any person pursuant to the governing instrument."

(c) FOREIGN INCOME.—Section 643(a)(6) is amended by adding "estate or" after "In the case of a foreign".

(d) CONFORMING AMENDMENT.—Section 643(a) is amended by striking out the last two sentences thereof.

(e) INCOME.—The second sentence of section 643(b) is amended to read as follows: "Items of gross income constituting extraordinary dividends, taxable stock dividends, or capital gains, which the fiduciary (acting in good faith) determines to be allocable to corpus under the terms of the governing instrument and applicable local law, shall not be considered income."

(f) BENEFICIARY.—Section 643(c) is amended to read as follows:

"(c) BENEFICIARY.—For purposes of this part, the term 'beneficiary' includes an heir, a legatee, and a devisee."

(g) CHARITABLE BENEFICIARY.—Section 643 is amended by adding at the end thereof the following new subsection:

"(d) CHARITABLE BENEFICIARY.—For purposes of this part, the term 'charitable beneficiary' means any beneficiary to or for the use of which a contribution by an individual would be a 'charitable contribution' under section 170(c) (without regard to the percentage limitations prescribed in section 170(b))."

SEC. 104. DEDUCTION FOR TRUSTS DISTRIBUTING CURRENT INCOME ONLY—AMENDMENT OF SECTION 651.

Section 651 is amended to read as follows:

"SEC. 651. DEDUCTION FOR TRUSTS DISTRIBUTING CURRENT INCOME ONLY.

"(a) DEDUCTION.—In the case of any trust—

"(1) the terms of which provide that all of its income is required to be distributed currently,

"(2) which in the taxable year does not pay or credit, and is not required to distribute, amounts other than amounts of income described in paragraph (1), and

"(3) with respect to which, for the taxable year, there is no amount described in section 661(a)(4) (relating to amounts paid or permanently set aside for charitable beneficiaries, etc.),

there shall be allowed as a deduction in computing the taxable income of the trust the amount of the income for the taxable year which is required to be distributed currently.

"(b) LIMITATION ON DEDUCTION.—If the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year, the deduction under subsection (a) shall be limited to the amount of the distributable net income. For this purpose the computation of distributable net income and income required to be distributed currently shall not include items of income (and the deductions allocable thereto) which are not included in the gross income of the trust. The character of the items of distributable net income and of income required to be distributed currently shall be determined in accordance with the rules stated in section 652(b)."

SEC. 105. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF TRUSTS DISTRIBUTING CURRENT INCOME ONLY—AMENDMENTS OF SECTION 652.

(a) CHARACTER OF AMOUNTS.—The second sentence of section 652(b) is amended by inserting "or applicable local law" after "the terms of the trust".

(b) DIFFERENT TAXABLE YEARS.—Section 652(c) is amended to read as follows:

"(c) DIFFERENT TAXABLE YEARS.—If the taxable year of a beneficiary is different from that of the trust, the amount to be included in the gross income of the beneficiary in accordance with the provisions of this section shall be—

"(1) based on the amount of income of the trust for any taxable year or years of the trust ending within or with the taxable year of the beneficiary, and

"(2) if the taxable year of the beneficiary terminates by reason of the death or other termination of existence of the beneficiary during a taxable year of the trust, based on the amount of income of the trust for the period from the end of its last preceding taxable year to the date of such termination of existence.

In computing distributable net income for purposes of the application of subsection (a) to a beneficiary described in paragraph (2), there shall be taken into account only those items of income properly allocable, and those deductions properly chargeable, under the terms of the governing instrument and applicable local law in determining such beneficiary's share of the income for such period."

SEC. 106. DEDUCTION FOR ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS—AMENDMENTS OF SECTION 661.

(a) DEDUCTION.—Section 661(a) is amended to read as follows:

"(a) DEDUCTION.—In any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of—

"(1) any amount (other than an amount described in paragraph (4)) required to be distributed currently to a beneficiary out of income for the taxable year, or paid or credited in the exercise of a discretion by the fiduciary to pay or credit such amount to a beneficiary to whom no amount may be paid or credited during the taxable year except from income for the taxable year;

"(2) any amount (other than an amount described in paragraph (4)) paid or credited in the exercise of a discretion by the fiduciary to pay or credit such amount to a benficiary to whom amounts may be paid or credited during the taxable year out of the income for the taxable year or out of corpus (including accumulated income of prior taxable years);

"(3) all other amounts (other than amounts described in paragraph (4)) properly paid or credited, or required to be distributed, to a beneficiary during the taxable year; and

"(4) any amount which, pursuant to the terms of the governing instrument, is paid or permanently set aside during the taxable year for a charitable beneficiary (as defined in section 643(d)) or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit.

The deduction under this subsection shall not exceed the distributable net income of the estate or trust. The deduction under paragraph (4) shall not exceed an amount equal to the distributable net income of the estate or trust, reduced by the amounts specified in paragraphs (1), (2), and (3)."

(b) CHARACTER OF AMOUNTS DISTRIBUTED.—Section 661(b) is amended by inserting "or applicable local law" before the period at the end of the first sentence thereof; and by striking out the parenthetical phrase "(including the deduction allowed under section 642(c))" in the second sentence thereof.

(c) LIMITATION ON CHARITABLE DEDUCTION.—Section 661 is amended by adding at the end thereof the following new subsection:

"(d) CROSS REFERENCE.—

"For limitation on charitable deduction in the case of a trust having unrelated business income, see section 681."

SEC. 107. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS—AMENDMENT OF SECTION 662.

(a) IN GENERAL.—Section 662 is amended to read as follows:

"SEC. 662. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS.

"(a) INCLUSION.—Subject to subsection (b), there shall be included in the gross income of a beneficiary to whom an amount specified in paragraph (1), (2), or (3) of section 661(a) is paid, credited, or required to be distributed (by an estate or trust described in section 661, the sum of the following amounts—

"(1) any amount required to be distributed currently to the beneficiary out of income for the taxable year, or paid or credited in the exercise of a discretion by the fiduciary to pay or credit such amount to the beneficiary to whom no amount may be paid or credited during the taxable year except from income for the taxable year;

"(2) any amount paid or credited in the exercise of a discretion by the fiduciary to pay or credit such amount to the beneficiary to whom amounts may be paid or credited during the taxable year out of the income for the taxable year or out of corpus (including accumulated income of prior taxable years); and

"(3) all other amounts properly paid or credited, or required to be distributed, to such beneficiary during the taxable year.

The amounts paid, credited, or required to be distributed which are referred to in paragraphs (1), (2), and (3) of this subsection shall be deemed paid out of the distributable net income of the estate or trust in the above order of priority. If the amounts paid to the beneficiaries in any one of such classes, taken in such order of priority, exceed the distributable net income of the estate or trust available to such class (after being reduced by the amount allocated to any prior class or classes), there shall be included in the gross income of the beneficiary an amount which bears the same ratio to the distributable net income available to that class as the amount paid, credited, or required to be distribued to such beneficiary within such class bears to the amount so paid, credited, or required to be distributed to all beneficiaries of such class.

"(b) CHARACTER OF AMOUNTS.—The amounts determined under subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument or applicable local law specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate.

"(c) DIFFERENT TAXABLE YEARS.—If the taxable year of a beneficiary is different from that of the estate or trust, the amount to be included in the gross income of the beneficiary shall be—

"(1) based on the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary during any taxable year or years of the estate or trust ending within or with the taxable year of the beneficiary, and

"(2) if the taxable year of the beneficiary terminates by reason of the death or other termination of existence of the beneficiary during a taxable year of the estate or trust, based on the amount of income of the estate or trust for the period from the end of its last preceding taxable year to the date of such termination of existence.

In computing distributable net income for purposes of the application of subsection (a) to a beneficiary described in paragraph (2), there shall be taken into account only those items of income properly allocable, and those deductions properly chargeable, under the terms of the governing instrument and applicable local law in determining such beneficiary's share of the income for such period."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply only in the case of taxable years of estates and trusts ending after the date of the enactment of this Act.

SEC. 108. SPECIAL RULES APPLICABLE TO SECTIONS 651, 652, 661, 662, ETC.—AMENDMENTS OF SECTION 663.

(a) EXCLUSIONS.—

(1) IN GENERAL.—Section 663(a) is amended to read as follows:

"(a) EXCLUSIONS.—There shall not be included as amounts falling within section 661(a) or 662(a)—

"(1) GIFTS, BEQUESTS, ETC., OF SPECIFIC SUMS OF MONEY OR OF SPECIFIC PROPERTY.—In the case of an estate, a trust created by will, or a trust which (immediately before the death of the grantor) was revocable by the grantor acting alone, any amount which is properly distributed as a gift, bequest, or devise of a specific sum of money or of specific property, and—

"(A) is distributed all at once or within one taxable year of the estate or trust if, under the terms of the governing instrument, such amount is not required to be paid in more than one taxable year of the estate or trust, or

"(B) is distributed before the close of the 36th calendar month which begins after the date of the death of the testator or grantor, if, under the terms of the governing instrument, no part of such amount is required to be distributed after the close of such month.

This paragraph shall not apply to any amount which can be distributed only from the income of the estate or trust.

"(2) OTHER GIFTS, BEQUESTS, ETC.—Any real property or tangible personal property (other than money) held by the decedent at the time of his death which is properly distributed, before the close of the 36th calendar month which begins after the date of the death of the decedent, in full or partial satisfaction of a bequest, share, award, or allowance from the corpus of a decedent's estate.

"(3) DENIAL OF DOUBLE DEDUCTION, ETC.—Any amount for which a deduction was allowed or allowable (or would have been allowable but for the limitations contained in section 661 (a) or (c)) for a preceding taxable year of an estate or trust because credited, required to be distributed, or permanently set aside in such preceding taxable year (or because to be used for purposes specified in section 661(a) (4))."

(2) EFFECTIVE DATE.—Paragraph (1) of section 663(a), as amended by paragraph (1) of this subsection, shall apply with respect to estates and trusts of decedents dying after the date of the enactment of this Act. Notwithstanding the preceding sentence, paragraph (1) of section 663(a), as in effect before the amendment made by paragraph (1) of this subsection, shall continue to apply with respect to trusts which are in existence on the date of the enactment of this Act and on such date are not revocable by the grantor acting alone, but only so long as such trusts are not so revocable.

(b) SEPARATE SHARES TREATED AS SEPARATE ESTATES OR TRUSTS.—

(1) AMENDMENT OF SECTION 663(c).—Section 663(c) is amended to read as follows:

"(c) SEPARATE SHARES TREATED AS SEPARATE ESTATES OR TRUSTS.—In the case of an estate or a single trust having more than one beneficiary, for purposes of determining—

"(1) the amount of distributable net income, and

"(2) whether a termination within the meaning of section 642(h) or section 643(a) (3) (B) has occurred,

substantially separate and independent shares of different beneficiaries in the estate or trust shall be treated as separate estates or trusts. The existence of such substantially separate and independent shares and the manner of treatment as separate estates or trusts, including the application of subpart D to such separate share trusts, shall be determined in accordance with regulations prescribed by the Secretary or his delegate."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply only in the case of taxable years of estates and trusts ending after the date of the enactment of this Act.

(c) REQUIRED DISTRIBUTION TO ANOTHER TRUST.—

(1) IN GENERAL.—Section 663 is amended by adding at the end thereof the following new subsection:

"(d) REQUIRED DISTRIBUTION TO ANOTHER TRUST.—In applying sections 661 and 662, if there is a distribution from one trust to another trust and if such distribution—

"(1) under the terms of the governing instrument or applicable local law, is required and is not payable solely out of income,

"(2) is not related to the occurrence of an event which causes the distributing trust to terminate, and

"(3) includes an amount (determined under regulations prescribed by the Secretary of his delegate) representing the receiving trust's share of the distributable net income of the distributing trust for that portion of the distributing trust's taxable year which ends on the date of such distribution,

then any deduction which (but for this subsection) would be allowable to the distributing trust by reason of such distribution shall not be allowed except to the extent of the amount described in paragraph (3). The receiving trust shall include in its gross income for its first taxable year which ends after the date of the distribution an amount equal to the amount described in paragraph (3). If there is a distribution from one trust to another trust which meets the requirements of paragraphs (1) and (2) of this subsection, then (under regulations prescribed by the Secretary or his delegate and to the extent consistent with the preceding provisions of this subsection and with section 665) the receiving trust shall succeed to (as of the date of the distribution) and shall take into account its proper share of the items of the distributing trust entering into the computation of the distributable net income of the distributing trust and of any carryover items; and such items (to the extent succeeded to by the receiving trust) shall not be taken into account by the distributing trust."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply only with respect to distributions made after the date of the enactment of this Act.

(d) TECHNICAL AMENDMENT.—The heading of section 663 is amended to read as follows:

"SEC. 663. SPECIAL RULES."

SEC. 109. POWER IN PERSON OTHER THAN GRANTOR TO VEST CORPUS OR INCOME IN HIMSELF.

(a) IN GENERAL.—Subpart C of part I of subchapter J of chapter 1 is amended by adding at the end thereof the following new section:

"SEC. 664. POWER IN PERSON OTHER THAN GRANTOR TO VEST CORPUS OR INCOME IN HIMSELF.

"(a) GENERAL RULES.—

"(1) AMOUNT CONSIDERED DISTRIBUTED, PAID, OR CREDITED.—If a person other than the grantor has a power exercisable solely by himself to vest an amount of corpus or income of a trust in himself—

"(A) in applying sections 651 and 652, such amount shall be treated as an amount of corpus or income, as the case may be—

"(i) required to be distributed currently to such person, and

"(ii) not paid, credited, or required to be distributed currently to any other person, and

"(B) in applying sections 661 and 662, such amount shall be treated as an amount of corpus or income, as the case may be—

"(i) required to be distributed to such person, and

"(ii) not paid, credited, or required to be distributed to any other person.

"(2) TREATMENT OF INCOME.—If a person other than the grantor has a power exercisable solely by himself to vest an amount of corpus in himself, then, in applying sections 651, 652, 661, and 662, the income attributable to such amount of corpus for the taxable year shall be considered as an amount of income—

"(A) required to be distributed currently to such person, and

"(B) not paid, credited, or required to be distributed currently to any other person.

For purposes of this paragraph, there shall be taken into account only income attributable to that portion of the taxable year which begins on the first day during such taxable year on which the power becames exercisable and ending on the day on which the power is exercised.

"(b) PERSON HAVING POWER TREATED AS GRANTOR.—Subsection (a) shall not apply if the person other than the grantor has previously released or modified a power described in subsection (a) and, after the release or modification, retained such control of the property released from the power as would, within the principles of subpart E, subject a grantor of a trust to treatment as the owner of such property. If subsection (a) does not apply by reason of the preceding sentence, such person shall be treated as the grantor of such property and taxed under subpart E.

"(c) OBLIGATIONS OF SUPPORT.—Subsection (a) shall not apply to a power which enables the person other than the grantor, in the capacity of trustee or cotrustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain, except to the extent that such income is so applied.

"(d) EFFECT OF RENUNCIATION OR DISCLAIMER.—Subsections (a) and (b) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

"(e) PERSON HAVING POWER TREATED AS OWNER FOR CERTAIN PURPOSES.—Except to the extent inconsistent with the provisions of this section, a person who has a power to which subsection (a) applies shall be treated (for purposes of this chapter other than this subchapter) as the owner of that portion of the trust with respect to which he has such power.

"(f) SUBSTANTIAL OWNERSHIP RULE INAPPLICABLE.—Except as specified in subsections (a) and (b), no items of income, deduction, or credit against tax of a trust shall be included solely on the grounds of dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, in computing the taxable income and credits of a person other than the grantor."

(b) REPEAL OF SECTION 678.—Section 678 is hereby repealed.

(c) EFFECTIVE DATE.—Subsections (a) and (b) shall apply in the case of taxable years of trusts beginning on or after the date of the enactment of this Act, and with respect to periods included in such taxable years.

SEC. 110. DEFINITIONS RELATING TO TREATMENT OF EXCESS DISTRIBUTIONS BY TRUSTS—AMENDMENTS OF SECTION 665.

(a) UNDISTRIBUTED NET INCOME.—Section 665(a) is amended to read as follows:

"(a) UNDISTRIBUTED NET INCOME.—For purposes of this subpart, the term 'undistributed net income' for any taxable year means the amount by which

distributable net income of the trust for such taxable year exceeds the sum of—

"(1) the amounts for such taxable year specified in paragraphs (1), (2), and (3) of section 661(a);

"(2) the amount for such taxable year specified in paragraph (4) of section 661(a), reduced by any amount disallowed under section 681; and

"(3) the amount of taxes imposed on the trust."

(b) ACCUMULATION DISTRIBUTION.—Section 665(b) is amended to read as follows:

"(b) ACCUMULATION DISTRIBUTION.—For purposes of this subpart, the term 'accumulation distribution' for any taxable year of the trust means the amount (if in excess of $2,000) by which the amounts specified in paragraphs (2) and (3) of section 661(a) for such taxable year exceed distributable net income, reduced by the amounts specified in paragraph (1) of section 661(a) for such taxable year. For purposes of this subsection, the amounts specified in paragraphs (2) and (3) of section 661(a) shall be determined without regard to section 668 and shall not include—

"(1) amounts properly paid or credited, or required to be distributed, to a beneficiary as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21;

"(2) amounts properly paid or credited to a beneficiary to meet the emergency needs of such beneficiary;

"(3) amounts properly paid or credited to a beneficiary upon a specified date or dates, or upon such beneficiary's attaining a specified age or ages, if—

"(A) the total number of such distributions cannot exceed 4 with respect to such beneficiary,

"(B) the period between each such distribution to such beneficiary is 4 years or more, and

"(C) as of January 1, 1954, such distributions are required by the specific terms of the governing instrument;

"(4) amounts properly paid or credited to a beneficiary as a final distribution of the trust, except to the extent that such distribution is attributable to property transferred to the trust not more than 9 years before such distribution and income attributable to the property so transferred;

"(5) amounts properly paid or credited to a beneficiary as a final distribution of a trust by reason of the beneficiary reaching an age specified in the governing instrument, if such trust was created by will or, immediately before the grantor's death, was revocable by him acting alone; or

"(6) amounts distributed to another trust, but only if such distribution—

"(A) under the terms of the governing instrument or applicable local law, is required and is not payable solely out of income, and

"(B) is not related to the occurrence of an event which causes the distributing trust to terminate."

(c) RULES FOR DISTRIBUTION TO OTHER TRUSTS.—Section 665 is amended by adding at the end thereof the following new subsection:

"(e) SPECIAL RULES FOR DISTRIBUTIONS TO OTHER TRUSTS.—For purposes of this subpart, in the case of amounts to which subsection (b)(6) applies—

"(1) such portion of the undistributed net income of the distributing trust for its preceding taxable years as corresponds to the portion of the trust property required to be distributed to the receiving trust, and such portion of the taxes imposed on the trust for such years as corresponds to such portion of the undistributed net income, shall be deemed undistributed net income of, and taxes imposed on, the receiving trust for its corresponding preceding taxable years (whether or not the receiving trust was in existence during such preceding taxable years); and

"(2) the undistributed net income of, and the taxes imposed on, the distributing trust shall be correspondingly reduced."

SEC. 111. ACCUMULATION DISTRIBUTION ALLOCATED TO 5 PRECEDING YEARS—AMENDMENTS OF SECTION 666.

Section 666 is amended by striking out "paragraph (2)" each place it appears and inserting in lieu thereof "paragraph (3)".

SEC. 112. TREATMENT OF AMOUNTS DEEMED DISTRIBUTED IN PRECEDING YEARS—AMENDMENT OF SECTION 668.

(a) IN GENERAL.—Section 668(a) is amended to read as follows:

"(a) AMOUNTS TREATED AS RECEIVED IN PRIOR TAXABLE YEARS.—The total of the amounts which are treated under section 666 as having been distributed by

the trust in a preceding taxable year shall be included in the income of a beneficiary or beneficiaries of the trust when paid, credited, or required to be distributed to the extent that such total would have been included in the income of such beneficiary or beneficiaries if section 662 (a)(3) and (b) had applied and if such total had been paid to such beneficiary or beneficiaries on the last day of such preceding taxable year. The portion of such total required to be included under the preceding sentence in the income of any beneficiary shall be an amount which bears the same ratio to such total as—

"(1)(A) the aggregate amount paid, credited, or required to be distributed to such beneficiary for the taxable year and described in paragraph (2) or (3) of section 661(a), reduced by (B) the amount of distributable net income for such taxable year allocated to such beneficiary under paragraph (2) or (3) of section 662(a), bears to

"(2)(A) all amounts paid, credited, or required to be distributed to all beneficiaries for the taxable year and described in paragraph (2) or (3) of section 661(a), reduced by (B) the amount of distributable net income for such taxable year allocated to all beneficiaries under paragraph (2) or (3) of section 662(a);

except that proper adjustment of such ratio shall be made, under regulations prescribed by the Secretary or his delegate, for amounts which fall within paragraphs (1) through (6) of section 665(b). The tax of the beneficiaries attributable to the amounts treated as having been received on the last day of such preceding taxable year of the trust shall not be greater than the aggregate of the taxes attributable to those amounts had they been included in the gross income of the beneficiaries on such day in accordance with section 662 (a)(3) and (b)."

(b) SPECIAL TRANSITIONAL RULE. In applying sections 666 and 668 of the Internal Revenue Code of 1954, as amended by section 111 and subsection (a) of this section, to any preceding taxable year of a trust to which such amendments do not apply, references to sections 661(a)(3) and 662(a)(3) shall be treated as references to sections 661(a)(2) and 662(a)(2) as in effect before such amendments.

SEC. 113. MULTIPLE TRUSTS.

(a) IN GENERAL.—Subpart D of part I of subchapter J of chapter 1 is amended by adding at the end thereof the following new section:

"SEC. 669. MULTIPLE TRUSTS.

"(a) GENERAL RULE.—In the case of a trust which, for a taxable year ending after the date of the enactment of this Act, makes a multiple trust distribution, the treatment of such trust and of the beneficiaries of such distribution shall be determined by applying sections 666 and 668 in respect of such distribution with the following modifications:

"(1) The term 'accumulation distribution' shall be read as 'multiple trust distribution'.

"(2) The term '5 preceding taxable years' shall be read as '10 preceding table years'.

"(3) Section 662(b) (relating to character of amount in hands of beneficiary) shall not apply.

"(4) In applying the last sentence of section 668(a) (relating to limit on tax on beneficiaries), the term 'shall not be greater than' shall be read as 'shall be equal to'.

"(b) DEFINITIONS.—For purposes of this subpart—

"(1) MULTIPLE TRUST DISTRIBUTION.—The term 'multiple trust distribution' means any section 669 distribution, to the extent paid, credited, or required to be distributed to any beneficiary with respect to whom—

"(A) part or all of a section 669 distribution from his primary trust has been paid, credited, or required to be distributed in a taxable year to which this subchapter applied, and

"(B) the trust making such distribution is not his primary trust.

To the extent that any amount is a multiple trust distribution, such amount shall not be treated as an accumulation distribution.

"(2) SECTION 669 DISTRIBUTION.—The term 'section 669 distribution' for any taxable year of a trust means the amount by which the amounts specified in paragraphs (2) and (3) of section 661(a) (determined without regard to section 666) for such taxable year exceed distributable net income,

reduced by the amounts specified in paragraph (1) of section 661(a) for such taxable year.

"(3) PRIMARY TRUST.—The term 'primary trust' means, with respect to any beneficiary, the trust which meets the following 3 conditions:

"(A) such trust is one of two or more trusts to which the same person contributed property,

"(B) such trust has coexisted at any time with the trust making the section 669 distribution, and

"(C) such trust is the trust which first made a section 669 distribution to such beneficiary in a taxable year of such trust to which this subchapter applied.

For purposes of subparagraph (C), if the first section 669 distributions occur in taxable years ending on the same date, subparagraph (C) will be treated as satisfied by the trust making the largest such section 669 distribution.

"(c) SPECIAL RULES.—

"(1) TWO OR MORE PERSONS CONTRIBUTING PROPERTY TO SAME TRUST.—For purposes of this section, a trust to which two or more persons contributed property, whether or not at different times, shall be treated as two or more separate trusts. The existence of such separate trusts, and the manner of treating them as separae trusts for purposes of this section, shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

"(2) TRUST WITH BOTH ACCUMULATION DISTRIBUTION AND MULTIPLE TRUST DISTRIBUTION FOR SAME YEAR.—If, for any taxable year of a trust, there is both an accumulation distribution and a multiple trust distribution with respect to such trust, then (under regulations prescribed by the Secretary or his delegate) in applying this section and in applying sections 666 and 668 both such distributions shall be taken into account to the extent and in the manner proper to carry out the purposes of this subpart.

"(3) COMPUTATION OF BENEFICIARY'S TAX IN CERTAIN CASES.—

"(A) IN GENERAL.—If a beneficiary cannot establish his taxable income for any taxable year described in subparagraph (B), then, in applying this section in the case of any multiple trust distribution to him, the last sentence of section 668(a) (relating to limit on tax on beneficiaries) shall not apply in respect of such taxable year or in respect to any preceding taxable year.

"(B) APPLICATION OF SUBPARAGRAPH (A).—A taxable year of a beneficiary shall be treated as described in this subparagraph if, by reason of this section—

"(i) amounts in respect of such taxable year are included in his income under section 668(a), and

"(ii) such amounts are treated under section 666 as having been distributed by the trust before the fifth taxable year preceding the taxable year for which the trust makes the multiple trust distribution.

"(d) DISCLOSURE OF INFORMATION.—The Secretary or his delegate may require—

"(1) any person who has contributed any property to two or more trusts (or his personal representative),

"(2) the trustee of any trust, and

"(3) any beneficiary of any trust,

to furnish to the Secretary or his delegate such information with respect to such trusts as may be necessary to carry out the purposes of this section."

(b) CONFORMING AMENDMENTS.—

(1) AMENDMENT OF SECTION 665(c).—The last sentence of section 665(c) is amended to read as follows: "The amount determined under the preceding sentence shall be reduced by any amount of such taxes allowed, under section 668, as a credit to any beneficiary on account of any accumulation distribution or multiple trust distribution determined for any taxable year."

(2) AMENDMENTS OF SECTION 666.—

(A) Subsections (a), (b), and (c) of section 666 are amended by striking out the last sentence of each such subsection.

(B) Section 666 is amended by adding at the end thereof the following new subsection:

"(d) EFFECT OF DISTRIBUTION IN OTHER TAXABLE YEARS.—For purposes of this section, the undistributed net income and the taxes imposed on the trust for any preceding taxable year shall be computed—

"(1) without regard to any distribution under this subpart for the taxable year and any succeeding taxable year, but

"(2) with regard to any distribution under this subpart for any preceding taxable year."

(3) AMENDMENT OF SECTION 667.—Section 667 is amended to read as follows:

"SEC. 667. DENIAL OF REFUND TO TRUSTS.

"The amount of taxes imposed on the trust under this chapter which would not have been payable by the trust for any preceding taxable year had the trust in fact made accumulation distributions and multiple trust distributions, at the times and in the amounts determined under section 666, shall not be refunded or credited to the trust."

(4) AMENDMENT OF SECTION 668(b).—Section 668(b) is amended to read as follows:

"(b) CREDIT FOR TAXES PAID BY TRUSTS.—There shall be allowed as a credit against the tax imposed on any beneficiary under this chapter the amount deemed distributed to such beneficiary under section 666 (b) or (c)."

(c) RETURNS BY TRUSTS MAKING DISTRIBUTIONS FROM ACCUMULATED INCOME.—

(1) Subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new section:

"SEC. 6047. RETURNS BY TRUSTS MAKING DISTRIBUTIONS FROM ACCUMULATED INCOME.

"(a) REQUIREMENT OF RETURN.—Every trust which makes a 'section 669 distribution' as defined in section 669(b)(2) (relating to multiple trusts) to any beneficiary in any taxable year shall make a return, with respect to such beneficiary, setting forth the name of the grantor of the trust, the name and address of the beneficiary, the amount of such distribution to him, and such other information as may be required by forms or regulations prescribed by the Secretary or his delegate.

"(b) INFORMATION TO BE FURNISHED BENEFICIARY.—The information required by subsection (a) shall be furnished by the trust to the beneficiary to whom the distribution was made in such manner, in such form, and at such time as may be required by regulations prescribed by the Secretary or his delegate."

(2) The table of sections for such subpart B is amended by adding at the end thereof the following:

"Sec. 6047. Returns by trusts making distributions from accumulated income."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to distributions for taxable years of trusts ending after the date of the enactment of this Act. In applying section 669(b)(2) (as added by subsection (a) of this section) to any preceding taxable year of a trust ending on or before the date of the enactment of this Act, the reference to paragraphs (2) and (3) of section 661(a) shall be treated as a reference to paragraph (2) of section 661(a) as in effect before the amendment made by section 106(a) of this Act, and the reference to paragraph (1) of section 661(a) shall be treated as a reference to such paragraph (1) as so in effect.

SEC. 114. TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AS SUBSTANTIAL OWNERS—AMENDMENT OF SECTION 671.

Section 671 is amended to read as follows:

"SEC. 671. TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AS SUBSTANTIAL OWNERS.

"Where it is specified in this subpart that the grantor shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the

trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of the grantor, and to that extent such items shall not be subject to subparts A through D. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart."

SEC. 115. POWER TO CONTROL BENEFICIAL ENJOYMENT—AMENDMENTS OF SECTION 674.

(a) POWER EXERCISABLE BY WILL OR BY DEED.—Section 674(b)(3) is amended to read as follows:

"(3) POWER EXERCISABLE BY WILL OR BY DEED.—A power exercisable—

"(A) by will, or

"(B) by deed where an exercise of the power would be effective to change beneficial enjoyment of the corpus or the income therefrom only after the death of the holder of the power,

other than a power in the grantor to appoint the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. This paragraph shall not apply to a power exercisable by deed which does not exclude the grantor and his estate as possible appointees."

(b) POWER TO DISTRIBUTE CORPUS.—Section 674(b)(5) is amended to read as follows:

"(5) POWER TO DISTRIBUTE CORPUS.—A power to distribute corpus either—

"(A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or

"(B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person other than an adverse party has a power (other than a power which would qualify as an exception under paragraph (3)) to change the beneficiary or beneficiaries or the class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children or an after-acquired spouse."

(c) POWER TO WITHHOLD INCOME TEMPORARILY.—

(1) IN GENERAL.—Section 674(b)(6) is amended to read as follows:

"(6) POWER TO WITHHOLD INCOME TEMPORARILY.—A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable—

"(A) to the beneficiary from whom distribution or application is withheld or to his estate, or

"(B) to the beneficiary from whom distribution or application is withheld, or if he does not survive a date of distribution which could reasonably be expected to occur within his lifetime—

"(i) to his appointees (or alternate takers in default of appointment) under any power of appointment, whether or not general (provided no appointment under a power other than a general power can be made to the grantor or his estate), or

"(ii) if he has no power of appointment, to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust instrument, or

"(C) to the appointees of the beneficiary from whom distribution or application is withheld (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which excludes the grantor and his estate as a possible appointee, and does not exclude from the class of possible appointees

any other person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

"(D) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by the accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument, or if any beneficiary does not survive a date of distribution which would reasonably be expected to occur within his lifetime—

"(i) to his appointees (or alternate takers in default of appointment) under any power of appointment, whether or not general (provided no appointment under a power other than a general power can be made to the grantor or his estate), or

"(ii) if he has no power of appointment, to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust instrument.

A power does not fall within the powers described in this paragraph if any person other than an adverse party has a power (other than a power which would qualify as an exception under paragraph (3)) to change the benficiary or beneficiaries or the class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children or an after-acquired spouse."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall take effect one year after the date of the enactment of this Act.

(d) POWER TO WITHHOLD INCOME DURING DISABILITY OF A BENEFICIARY.—Section 674(b)(7) is amended to read as follows:

"(7) POWER TO WITHHOLD INCOME DURING DISABILITY OF A BENEFICIARY.—A power exercisable only during—

"(A) the existence of a legal disability of any current income beneficiary, or

"(B) the period during which any income beneficiary shall be under the age of 21 years,

to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in this paragraph if any person other than an adverse party has a power (other than a power which would qualify as an exception under paragraph (3)) to change the beneficiary or beneficiaries or the class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children or an after-acquired spouse.

(e) EXCEPTION FOR CERTAIN POWERS OF INDEPENDENT TRUSTEES.—Section 674(c) is amended to read as follows:

"(c) EXCEPTION FOR CERTAIN POWERS OF INDEPENDENT TRUSTEES.—Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees other than the grantor and which is not exercisable without the concurrence of a trustee who is not a related or subordinate party subservient to the wishes of the grantor—

"(1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or

"(2) to pay out corpus to or for a beneficiary or beneficiaries, or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the powers described in this subsection if any person other than an adverse party has a power (other than a power which would qualify as an exception under subsection (b)(3)) to change the beneficiary or beneficiaries or the class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children or an after-acquired spouse."

(f) POWER TO ALLOCATE INCOME IF LIMITED BY A STANDARD.—Section 674(d) is amended to read as follows:

"(d) POWER TO ALLOCATE INCOME IF LIMITED BY A STANDARD.—Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, other than the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard

which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person other than an adverse party has a power (other than a power which would qualify as an exception under subsection (b)(3)) to change the beneficiary or beneficiaries or the class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children or an after-acquired spouse."

SEC. 116. ADMINISTRATIVE POWERS—AMENDMENT OF SECTION 675.

Paragraph (2) of section 675 is amended by striking out "(other than the grantor)" and by inserting in lieu thereof "(other than the grantor acting alone)".

SEC. 117. INCOME FOR BENEFIT OF GRANTOR—AMENDMENTS OF SECTION 677.

(a) OBLIGATIONS OF SUPPORT.—The second sentence of section 677(b) is amended by striking out "paragraph (2)" and inserting in lieu thereof "paragraph (3)".

(b) EXISTENCE OF DISCRETION AS TO INCOME.—Section 677 is amended by adding at the end thereof the following new subsection:

"(c) EXISTENCE OF DISCRETION AS TO INCOME.—For purposes of this section, discretion exists—

"(1) to distribute income to the grantor,

"(2) to apply income to the payment of premiums on policies of insurance on the life of the grantor, or

"(3) to apply or distribute income for the support and maintenance of a beneficiary whom the grantor is legally obligated to support or maintain,

even though the terms of the trust specify that the discretion relates only to corpus, to the extent that the income of the trust is not required to be distributed currently."

SEC. 118. LIMITATION ON CHARITABLE DEDUCTION—AMENDMENTS OF SECTION 681.

(a) CONFORMING AMENDMENT.—Except as provided in subsection (b), section 681 is amended by striking out "section 642(c)" wherever it appears and inserting in lieu thereof "section 661(a)(4)".

(b) TECHNICAL AMENDMENTS.—Section 681(b)(1) and the first sentence of section 681(c) are amended by striking out "(computed without the benefit of section 642(c) but with the benefit of section 170(b)(1)(A))" and inserting in lieu thereof "(or 30 percent in the case of a beneficiary described in section 170(b)(1)(A))". Section 681(d) is amended by striking out "section 642(c)" and inserting in lieu thereof "section 661(a)(4)".

SEC. 119. CONFORMING AMENDMENTS.

(a) CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.—Section 170(e)(1) is amended by striking out "section 642(c)" and inserting in lieu thereof "sections 643(d) and 661(a)(4)".

(b) CONSTRUCTIVE OWNERSHIP OF STOCK.—The fourth sentence of section 318(a)(2)(B) is amended by striking out "(relating to grantors and others treated as substantial owners)" and inserting in lieu thereof "(relating to grantors treated as substantial owners), or is treated as the grantor or owner by reason of section 604 (b) or (e),".

(c) DISALLOWANCE OF CERTAIN CHARITABLE, ETC., DEDUCTIONS.—Section 503(e) is amended by striking out "642(c), 545(b)(2)" and inserting in lieu thereof "545(b)(2), 661(a)(4)".

(d) STOCK OWNERSHIP REQUIREMENT.—Section 542(a)(2) is amended by striking out "section 642(c)" and inserting in lieu thereof "section 661(a)(4)".

(e) DEDUCTION FOR CAPITAL GAINS.—The second sentence of section 1202 is amended to read as follows: "In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any) of the gains for the taxable year from sales or exchanges of capital assets which is deductible under sections 651 and 661 (relating to deduction for distributions to beneficiaries)."

(f) RETURNS BY TRUSTS CLAIMING CHARITABLE DEDUCTIONS.—

(1) Section 6034 is amended by striking out "section 642(c)" whenever it appears and inserting in lieu thereof "section 661(a)(4)".

(2) The heading of section 6034 is amended by striking out "SECTION 642(c)" and inserting in lieu thereof "SECTION 661(a)(4)".

(3) The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by striking out

"Sec. 6034. Returns by trusts claiming charitable deductions under section 642(c)."

and inserting in lieu thereof

"Sec. 6034. Returns by trusts claiming charitable deductions under section 661(a)(4)."

(g) EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX.—Section 6166(h)(2)(B)(i) is amended by striking out "paragraphs (1) and (2) of section 661(a)" and inserting in lieu thereof "paragraphs (1), (2), (3), and (4) of section 661(a)".

SEC. 120. CLERICAL AMENDMENTS.

(a) The table of sections for subpart C of part I of subchapter J of chapter 1 is amended to read as follows:

"Subpart C—Estates and Trusts Which May Accumulate Income or Which Distribute Corpus

"Sec. 661. Deduction for estates and trusts accumulating income or distributing corpus.
"Sec. 662. Inclusion of amounts in gross income of beneficiaries of estates and trusts accumulating income or distributing corpus.
"Sec. 663. Special rules.
"Sec. 664. Power in person other than grantor to vest corpus or income in himself."

(b) The table of sections for subpart D of part I of subchapter J of chapter 1 is amended by adding at the end thereof:

"Sec. 669. Multiple trusts."

(c) The heading and table of sections for subpart E of part I of subchapter J of chapter 1 is amended to read as follows:

"Subpart E—Grantors Treated as Substantial Owners

"Sec. 671. Trust income, deductions, and credits attributable to grantors as substantial owners.
"Sec. 672. Definitions and rules.
"Sec. 673. Reversionary interests.
"Sec. 674. Power to control beneficial enjoyment.
"Sec. 675. Administrative powers.
"Sec. 676. Power to revoke.
"Sec. 677. Income for benefit of grantor."

(d) The table of subparts for part I of subchapter J of chapter 1 is amended by striking out "and others" in the reference to subpart E.

SEC. 121. EFFECTIVE DATE.

Except as otherwise provided in this title, the amendments made by this title shall apply with respect to taxable years ending after the date of the enactment of this Act.

TITLE II—PARTNERS AND PARTNERSHIPS

SEC. 201. AMENDMENT OF SUBCHAPTER K OF CHAPTER 1 OF THE INTERNAL REVENUE CODE OF 1954.

Subchapter K of chapter 1 is amended to read as follows:

"Subchapter K—Partners and Partnerships

"Part I. Rules generally applicable to partners and partnerships.
"Part II. Collapsible partnership transactions.
"Part III. Special rules for partners and partnerships.
"Part IV. Definitions.

"PART I—RULES GENERALLY APPLICABLE TO PARTNERS AND PARTNERSHIPS

"Subpart A. Determination of tax liability.
"Subpart B. Contributions to a partnership.
"Subpart C. Distributions by a partnership.
"Subpart D. Transfers of interests in a partnership.
"Subpart E. Treatment of certain liabilities.

"Subpart A—Determination of Tax Liability

"Sec. 701. Partners, not partnership, subject to tax.
"Sec. 702. Income and credits of partner.
"Sec. 703. Partnership computations.
"Sec. 704. Partner's distributive share.
"Sec. 705. Determination of basis of partner's interest.
"Sec. 706. Taxable years of partner and partnership.
"Sec. 707. Transactions between partner and partnership.
"Sec. 708. Continuation of partnership.

"SEC. 701. PARTNERS, NOT PARTNERSHIP, SUBJECT TO TAX.

"A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

"SEC. 702. INCOME AND CREDITS OF PARTNER.

"(a) GENERAL RULE.—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

"(1) gains and losses from sales or exchanges of capital assets held for not more than 6 months,

"(2) gains and losses from sales or exchanges of capital assets held for more than 6 months,

"(3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),

"(4) charitable contributions (as defined in section 170(c)),

"(5) dividends with respect to which there is provided a credit under section 34, an exclusion under section 116, or a deduction under part VIII of subchapter B,

"(6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

"(7) partially tax-exempt interest on obligations of the United States or on obligations of instrumentalities of the United States as described in section 35 or section 242 (but, if the partnership elects to amotrize the premiums on bonds as provided in section 171, the amount received on such obligations shall be reduced by the reduction provided under section 171(a)(3)),

"(8) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary or his delegate, and

"(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

"(b) CHARACTER OF ITEMS CONSTITUTING DISTRIBUTIVE SHARE.—The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under subsection (a) or (e)(1)(A) shall be determined as if such item were realized or incurred directly by the partner from the source from which realized or incurred by the partnership. In making any such determination, due regard shall be given to any business, financial operation, or venture in which the partnership is engaged.

"(c) GROSS INCOME OF A PARTNER.—In any case where it is necessary to determine the amount of the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership; except that for purposes of section 61(a) (relating to gross income) such amount shall not include payments otherwise included in gross income for such purposes by reason of section 707(b).

"(d) LIMITATIONS IN COMPUTING TAXABLE INCOME, ETC.—If any limitation on the amount of the exclusion or deduction of any item of income, gain, loss, or deduction affecting the computation of taxable income, or on the amount of any credit, is expressed in terms of a fixed amount, or a percentage of income, such limitation shall be applied only to the partner and not to the partnership.

"(e) ELECTION FOR SIMPLIFIED REPORTING.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary or his delegate, if a partnership all the members of which are individuals elects for any taxable year to apply this subsection, then, in lieu of subsection (a), in determining his income tax each partner —

"(A) shall take into account separately his distributive share of the partnership items referred to in paragraphs (1), (2), (3), and (5) of subsection (a),

"(B) shall take into account an amount representing his distributive share of all remaining items of income, gain, loss, or deduction properly includible or allowable with respect to such individual in computing his taxable income, and

"(C) except as provided in subparagraph (A), shall not take into account any credit attributable to his distributive share of any partnership item.

"(2) APPLICATION OF PARAGRAPH (1)(B).—In determining the amount described in paragraph (1)(B)—

"(A) the deductions referred to in section 703 (a)(2) shall not be allowed, and

"(B) no deduction shall be allowed, and no exclusion shall apply, which under any other provision of this title is limited to a fixed amount or a percentage of income.

"(3) TIME FOR ELECTION, ETC.—The election provided by paragraph (1) may be made for any partnership taxable year, but only if made not later than the time prescribed by law for filing the partnership return for such taxable year (including extensions thereof). Any election made under this subsection may not be revoked except with the consent of the Secretary or his delegate.

"SEC. 703. PARTNERSHIP COMPUTATIONS.

"(a) INCOME AND DEDUCTIONS.—The taxable income of a partnership shall be computed in the same manner as in the case of an individual, except that—

"(1) the items described in section 702(a) shall be separately stated;

"(2) the following deductions shall not be allowed to the partnership:

"(A) the standard deduction provided in section 141,

"(B) the deductions for personal exemptions provided in section 151,

"(C) the deduction for taxes provided in section 164(a) with respect to taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

"(D) the deduction for charitable contributions provided in section 170,

"(E) the net operating loss deduction provided in section 172, and

"(F) the additional itemized deductions for individuals provided in part VII of subchapter B (sec. 211 and following); and

"(3) the deduction provided by subsection (b) of this section shall be allowed.

"(b) DEDUCTION OF ORGANIZATIONAL EXPENSES OF PARTNERSHIP.—

"(1) ALLOWANCE OF DEDUCTION.—A deduction, taken into account in the manner provided in paragraph (2), shall be allowed to the partnership for the organizational expenses (as defined in paragraph (3)) of the partnership.

"(2) PERIOD FOR WHICH DEDUCTION IS ALLOWABLE.—The deduction for organizational expenses of the partnership shall be taken into account by the partnership—

"(A) ratably over a period of 60 months beginning with the month in which such expenses are paid or accrued, and

"(B) any organizational expenses not previously deductible by the partnership shall be deductible by the partnership for its last taxable year.

"(3) DEFINITION OF ORGANIZATIONAL EXPENSES.—For purposes of this subsection, the term 'organizational expenses' means any expenditure paid or accrued, in a partnership taxable year to which this subsection applies, which—

"(A) is incident to the creation of the partnership, or for the preparation of the initial written partnership agreement (but not including any revision thereof or substitute therefor), and

"(B) is chargeable to capital account; except that such term does not include expenditures paid or accrued to obtain capital contributions for such partnership or which are incident to the transfer of assets to such partnership.

"(c) ELECTIONS OF THE PARTNERSHIP.—Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that the election under section 901 (relating to taxes of foreign countries and possessions of the United States) shall be made by each partner separately.

"SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

"(a) EFFECT OF PARTNERSHIP AGREEMENT.—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, section 761 (relating to special rules for contributed property), and section 762 (relating to family partnerships), be determined by the partnership agreement.

"(b) DISTRIBUTIVE SHARE DETERMINED BY INCOME OR LOSS RATIO.—A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9), for the taxable year, if—

"(1) the partnership agreement does not provide as to the partner's distributive share of such item, or

"(2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

"(c) CONTRIBUTED PROPERTY.—In determining a partner's distributive share of items described in section 702(a), depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, except to the extent otherwise provided in section 761 (relating to special rules for contributed property), be allocated among the partners in the same manner as if such property had been purchased by the partnership.

"(d) LIMITATION ON ALLOWANCE OF LOSSES.—A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

"SEC. 705. DETERMINATION OF BASIS OF PARTNER'S INTEREST.

"(a) GENERAL RULE.—The adjusted basis of a partner's interest in a partnership shall be determined by reference to his proportionate share of the adjusted basis of partnership property as if there had been a termination of the partnership.

"(b) LIMITATIONS.—The adjusted basis of a partner's interest shall not be determined under subsection (a) but shall be determined under section 763 if—

"(1) the partnership so elects (in accordance with regulations prescribed by the Secretary or his delegate), or

"(2) the partner fails to establish to the satisfaction of the Secretary or his delegate, if requested to do so in connection with, or subsequent to, the examination of his income tax return, that there has been no—

"(A) contribution to the partnership,

"(B) transfer of an interest in the partnership,

"(C) distribution by the partnership, or

"(D) other circumstance,

which would result in a substantial difference between the basis for the partner's interest computed under this section and his basis as computed under section 763.

Notwithstanding paragraph (2), subsection (a) shall apply if the adjusted basis determined under such subsection is further adjusted (as required by regulations prescribed by the Secretary or his delegate) in a manner which eliminates any such substantial difference.

"SEC. 706. TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

"(a) YEAR IN WHICH PARTNERSHIP INCOME IS INCLUDIBLE.—In computing the taxable income of a partner for a taxable year, the inclusions required by section

702 and section 707(b) with respect to a partnership shall be based on the income, gain, loss, deduction, or credit of the partnership for any taxable year of the partnership ending within or with the taxable year of the partner.

"(b) ADOPTION OR CHANGE OF TAXABLE YEAR.—

(1) PARTNERSHIP'S TAXABLE YEAR.—The taxable year of a partnership shall be determined as though the partnership were a taxpayer. A partnership may not

"(A) adopt a taxable year other than that of all its principal partners (except that if all the principal partners do not have the same taxable year, the partnership may adopt a calendar year), or

"(B) change to a taxable year other than that of all its principal partners,

unless it establishes, to the satisfaction of the Secretary or his delegate, a business purpose therefor.

"(2) PARTNER'S TAXABLE YEAR.—A partner may not change his taxable year except as provided in section 442.

"(3) PRINCIPAL PARTNER.—For purposes of this subsection, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

"(c) CLOSING OF PARTNERSHIP YEAR.—Except in the case of a termination of a partnership and except as provided in section 764 (relating to the closing of the taxable year of a partnership with respect to a deceased partner and with respect to a partner who sells or exchanges an interest in the partnership), the taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership.

"SEC. 707. TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP.

"(a) PARTNER NOT ACTING IN CAPACITY AS PARTNER.—If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in subsection (b) and in section 765 (relating to certain sales or exchanges of property with respect to controlled partnerships), be considered as occurring between the partnership and one who is not a partner.

"(b) GUARANTEED PAYMENTS.—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).

"SEC. 708. CONTINUATION OF PARTNERSHIP.

"(a) GENERAL RULE.—For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

"(b) TERMINATION.—

"(1) GENERAL RULE.—For purposes of subsection (a), a partnership shall be considered as terminated only if—

"(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

"(B) within a 12-month period there are sales and exchanges which aggregate 50 percent or more of the total interest in partnership capital and profits.

For purposes of subparagraph (B), there shall not be treated as a sale or exchange any sale to or exchange with a person who, on the date of such sale or exchange, has been a member of the partnership for a period of 12 months or more.

"(2) CROSS REFERENCE.—

"For special rules to be applied in the case of mergers or consolidations and divisions of partnerships, see section 766.

"Subpart B—Contributions to a Partnership

"Sec. 721. Nonrecognition of gain or loss on contribution.
"Sec. 722. Basis of contributing partner's interest.
"Sec. 723. Basis of property contributed to partnership.

"SEC. 721. NONRECOGNITION OF GAIN OR LOSS ON CONTRIBUTION.

"(a) GENERAL RULE.—No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

"(b) CROSS REFERENCE.—

"For provision relating to interest in partnership capital exchanged for services, see section 770.

"SEC. 722. BASIS OF CONTRIBUTING PARTNER'S INTEREST.

"The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution. The basis of an interest in a partnership acquired in exchange for the performance of services for the partnership shall be the amount deemed to be a contribution to the partnership under section 770(a).

"SEC. 723. BASIS OF PROPERTY CONTRIBUTED TO PARTNERSHIP.

"The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of of the contribution.

"Subpart C—Distributions by a Partnership

"Sec. 731. Extent of recognition of gain or loss on distribution.
"Sec. 732. Basis of distributed property other than money.
"Sec. 733. Basis of distributee partner's interest.
"Sec. 734. Basis of undistributed partnership property.
"Sec. 735. Character of gain or loss on disposition of distributed section 751 assets.
"Sec. 736. Holding period for distributed property.

"SEC. 731. EXTENT OF RECOGNITION OF GAIN OR LOSS ON DISTRIBUTION.

"(a) PARTNERS.—In the case of a distribution by a partnership to a partner—

"(1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

"(2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than money and section 751 assets is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of—

"(A) any money distributed, and

"(B) the basis to the distributee, as determined under section 732, of any section 751 assets.

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

"(b) PARTNERSHIPS.—No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.

"(c) EXCEPTIONS.—This section shall not apply to the extent otherwise provided by section 750 (relating to distributions of certain section 751 assets) and section 776 (relating to amounts paid to a retiring partner or a deceased partner's successor in interest).

"SEC. 732. BASIS OF DISTRIBUTED PROPERTY OTHER THAN MONEY.

"(a) DISTRIBUTIONS OTHER THAN IN LIQUIDATION OF A PARTNER'S INTEREST.—

"(1) GENERAL RULE.—The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in paragraph (2), be its adjusted basis to the partnership immediately before such distribution.

"(2) LIMITATION.—The basis to the distributee partner of property to which paragraph (1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

"(b) DISTRIBUTION IN LIQUIDATION.—The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

"(c) ALLOCATION OF BASIS.—The basis of distributed properties to which subsection (a)(2) or subsection (b) is applicable shall be allocated—

"(1) first to any section 751 assets in an amount equal to the adjusted basis of each such property to the partnership (or if the basis to be allocated is less than the sum of the adjusted bases of such properties to the partnership, in proportion to such bases), and

"(2) to the extent of any remaining basis, to any other distributed properties in proportion to their adjusted bases to the partnership.

"(d) EXCEPTION.—This section shall not apply to the extent that a distribution is treated as a sale or exchange of property under section 750 (relating to distributions of certain section 751 assets).

"SEC. 733. BASIS OF DISTRIBUTEE PARTNER'S INTEREST.

"In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by—

"(1) the amount of any money distributed to such partner, and

"(2) the amount of the basis to such partner of distributed property other than money, as determined under section 732.

"SEC. 734. BASIS OF UNDISTRIBUTED PARTNERSHIP PROPERTY.

"The basis of partnership property shall not be adjusted as the result of a distribution of property to a partner, unless the election provided by section 780(1) (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership.

"SEC. 735. CHARACTER OF GAIN OR LOSS ON DISPOSITION OF DISTRIBUTED SECTION 751 ASSETS.

"Gain or loss on the disposition by a distributee partner (or by a person whose basis for any property received from such distributee partner is determined in whole or in part by reference to the basis of such property in the hands of such distributee partner) of section 751 assets shall be considered gain or loss from the sale or exchange of property other than a capital asset.

"SEC. 736. HOLDING PERIOD FOR DISTRIBUTED PROPERTY.

"In determining the period for which a partner has held property received in a distribution from a partnership, there shall be included the holding period of the partnership, as determined under section 1223, with respect to such property.

"Subpart D—Transfers of Interests in a Partnership

"Sec. 741. Recognition and character of gain or loss on sale or exchange.
"Sec. 742. Basis of transferee partner's interest.
"Sec. 743. Basis of partnership property.

"SEC. 741. RECOGNITION AND CHARACTER OF GAIN OR LOSS ON SALE OR EXCHANGE.

"In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided by section 749 (relating to sales or exchanges of interests in partnerships resulting in ordinary income).

"SEC. 742. BASIS OF TRANSFEREE PARTNER'S INTEREST.

"The basis of an interest in a partnership acquired other than by contribution shall be determined under part II of subchapter O (sec. 1011 and following).

"SEC. 743. BASIS OF PARTNERSHIP PROPERTY.

"The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner, unless the election provided by section 780(2) (relating to optional

adjustment to basis of partnership property for transfers of partnership interests) is in effect with respect to such partnership.

"Subpart E—Treatment of Certain Liabilities

"Sec. 746. Treatment of certain liabilities.

"SEC. 746. TREATMENT OF CERTAIN LIABILITIES.

"(a) INCREASE IN PARTNER'S LIABILITIES.—Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

"(b) DECREASE IN PARTNER'S LIABILITIES.—Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

"(c) LIABILITY TO WHICH PROPERTY IS SUBJECT.—For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

"(d) SALE OR EXCHANGE OF AN INTEREST.—In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

"PART II—COLLAPSIBLE PARTNERSHIP TRANSACTIONS

"Sec. 749. Sales and exchanges of interests in partnerships which result in ordinary income.
"Sec. 750. Distributions which result in ordinary income.
"Sec. 751. Definition of section 751 assets and substantially appreciated section 751 assets.

"SEC. 749. SALES AND EXCHANGES OF INTERESTS IN PARTNERSHIPS WHICH RESULT IN ORDINARY INCOME.

"The amount of any money, and the fair market value of any property other than money, received by a transferor partner in exchange for all or a part of his interest in a partnership, to the extent attributable to substantially appreciated section 751 assets, shall be considered as an amount realized from the sale or exchange of property other than a capital asset. Any gain attributable to such assets shall be reduced (but not below zero) by any section 751(b) loss in the same transaction. This section shall apply without regard to whether there is gain or loss on the sale or exchange of the partnership interest.

"SEC. 750. DISTRIBUTIONS WHICH RESULT IN ORDINARY INCOME.

"(a) CERTAIN DISTRIBUTIONS TREATED AS SALES OR EXCHANGES.—To the extent a partner receives in a distribution—

"(1) partnership property which is substantially appreciated section 751 assets in exchange for all or part of his interest in other partnership property (including money), or

"(2) partnership property (including money) other than substantially appreciated section 751 assets in exchange for all or a part of his interest in partnership property which is substantially appreciated section 751 assets,

such transactions shall, under regulations prescribed by the Secretary or his delegate, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution). Any gain recognized to the distributee partner, or to the partnership (as constituted after the distribution), as the case may be, which is attributable to substantially appreciated section 751 assets shall be reduced (but not below zero) by any section 751(b) loss in the same transaction.

"(b) EXCEPTIONS.—Subsection (a) shall not apply to—

"(1) a distribution of property which the distributee contributed to the partnership.

"(2) payments, described in section 776(a), to a retiring partner or successor in interest of a deceased partner, or

"(3) a distribution of the partner's distributive share of the partnership income for the current year (including drawings and advances).

"SEC. 751. DEFINITIONS OF SECTION 751 ASSETS AND SUBSTANTIALLY APPRECIATED SECTION 751 ASSETS.

"(a) SECTION 751 ASSETS.—For purposes of this subchapter, the term 'section 751 assets' means all property of the partnership except—

"(1) capital assets,

"(2) property the gain on the sale or exchange of which would be treated as gain from the sale of a capital asset held for more than 6 months, and

"(3) property described in section 1231(b).

"(b) SECTION 751(b) LOSS.—For purposes of sections 749 and 750, the term 'section 751(b) loss' means the amount of any net loss which would result from the separate application of section 1231 with respect to all partnership property treated as sold or exchanged, if all such property were sold at its fair market value. In applying this subsection for purposes of section 750, separate determinations shall be made for the distributee partner and for the partnership (as constituted after the distribution).

"(c) RULES FOR THE APPLICATION OF SUBSECTIONS (a) AND (b).

"(1) CHARACTER OF PROPERTY.—For purposes of subsections (a) and (b), the character of any property shall be determined at the time of the sale or exchange of the interest (or at the time of distribution) as if all property treated as sold or exchanged were sold directly by the person (or persons) relinquishing an interest in the property (giving due regard to any business, financial operation, or venture in which the partnership is engaged) and as if all such property had been sold to one person in one transaction.

"(2) PROPERTY HELD FOR NOT MORE THAN 6 MONTHS.—For purposes of subsections (a) and (b), all property of the partnership shall be deemed to have been held for more than 6 months (or for 12 months or more in the case of livestock described in section 1231(b)(3)) whether or not so held.

"(d) SUBSTANTIALLY APPRECIATED SECTION 751 ASSETS.—Section 751 assets shall be considered to be substantially appreciated section 751 assets if their fair market value exceeds—

"(1) 120 percent of the adjusted basis to the partnership of the section 751 assets, and

"(2) 10 percent of the fair market value of all partnership property, other than money, reduced by the liabilities of the partnership.

"PART III—SPECIAL RULES FOR PARTNERS AND PARTNERSHIPS

"Subpart A. Special rules in determining tax liability.
"Subpart B. Interest in partnership capital exchanged for services.
"Subpart C. Termination of retiring or deceased partner's interest.
"Subpart D. Election of optional adjustments to basis of partnership property.

"Subpart A—Special Rules in Determining Tax Liability

"Sec. 761. Special rules for contributed property.
"Sec. 762. Family partnerships.
"Sec. 763. Alternative rule for determination of basis of partner's interest.
"Sec. 764. Closing of partnership taxable year for deceased partner or partner who sells or exchanges part or all of interest.
"Sec. 765. Certain sales or exchanges of property with respect to controlled partnerships.
"Sec. 766. Continuing partnership in mergers or consolidations and divisions.

"SEC. 761. SPECIAL RULES FOR CONTRIBUTED PROPERTY.

"(a) EFFECT OF PARTNERSHIP AGREEMENT.—If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Secretary or his delegate, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

"(b) UNDIVIDED INTERESTS.—If the partnership agreement does not provide otherwise, depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership shall be determined as though such undivided interests had not been contributed to the partnership. This

subsection shall apply only if all the partners had undivided interests in such property prior to contribution and their interests in the capital and profits of the partnership correspond with such undivided interests.

"(c) CROSS REFERENCE.—

"For general rule for the treatment of depreciation, depletion, or gain or loss on contributed property, see section 704(c).

"SEC. 762. FAMILY PARTNERSHIPS.

"(a) RECOGNITION OF INTEREST CREATED BY PURCHASE OR GIFT.—A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

"(b) DISTRIBUTIVE SHARE OF DONEE INCLUDIBLE IN GROSS INCOME.—In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

"(c) PURCHASE OF INTEREST BY MEMBER OF FAMILY.—For purposes of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The 'family' of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

"SEC. 763. ALTERNATIVE RULE FOR DETERMINATION OF BASIS OF PARTNER'S INTEREST.

"If section 705(a) is not applicable, the adjusted basis of a partner's interest in a partnership shall be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests)—

"(1) increased by the sum of his distributive share for the taxable year and prior taxable years of—

"(A) taxable income of the partnership as determined under section 703(a),

"(B) income of the partnership exempt from tax under this title, and

"(C) the excess of the deductions for depletion over the basis of the property subject to depletion; and

"(2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of—

"(A) losses of the partnership, and

"(B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

"SEC. 764. CLOSING OF PARTNERSHIP TAXABLE YEAR FOR DECEASED PARTNER OR PARTNER WHO SELLS OR EXCHANGES PART OR ALL OF INTEREST.

"(a) DEATH OF PARTNER.—The taxable year of a partnership shall close with respect to a deceased partner as of the date of death of such partner, unless his successor in interest files an election not to close the taxable year of the partnership with respect to such partner as of such date. Such election shall be filed in accordance with regulations prescribed by the Secretary or his delegate. In the event such election is filed, the taxable year of the partnership shall close with respect to such deceased partner as of whichever of the following is first to occur—

"(1) the close of the partnership taxable year,

"(2) the date of the first sale, exchange, or reduction occurring after his death of any part of the interest of the deceased partner, or

"(3) the day following the death of such partner if any part of the interest of such partner is sold, exchanged, or reduced at death by reason of an agreement which is operative on the death of such partner.

to be substantial or the interest is disposed of (other than by death, where the substantial restrictions or limitations continue), whichever first occurs, and shall be the lesser of—

"(i) the fair market value of the services, or

"(ii) the fair market value the interest would have had at the time of the exchange had there then been no such restrictions or limitations.

"(2) LIMITATION ON DEDUCTION UNDER SUBSECTION (b)(1).—The amount of the deduction under subsection (b)(1) shall not exceed the aggregate amount determined by taking into account, with respect to each relinquishing partner, whichever of the following is the lesser:

"(A) his adjusted basis (as of the time of the exchange) in the relinquished interest, or

"(B) that portion of the amount determined under paragraph (1) which is attributable to his relinquishment.

"Subpart C—Termination of Retiring or Deceased Partner's Interest

"Sec. 776. Amounts paid to a retiring partner or a deceased partner's success or in interest.
"Sec. 777. Cross references relating to partnership income treated as income in respect of decedent and exception as to application of rule for property acquired from a decedent.

"SEC. 776. AMOUNTS PAID TO A RETIRING PARTNER OR A DECEASED PARTNER'S SUCCESSOR IN INTEREST.

"(a) AMOUNTS CONSIDERED AS DISTRIBUTIVE SHARES OR GUARANTEED PAYMENTS.—

"(1) AMOUNTS TO WHICH SUBSECTION IS APPLICABLE.—Amounts payable in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

"(A) as a distributive share of partnership income to the recipient if the amount thereof—

"(i) is determined with regard to the income of the partnership, and

"(ii) is paid, or payable, on or before the fifteenth day of the fourth month following the close of the partnership taxable year with respect to which such amount is determined, or

"(B) as if they were a guaranteed payment described in section 707(b) if subparagraph (A) is not applicable.

"(2) TIME AMOUNTS PAYABLE ARE TAKEN INTO ACCOUNT.—

"(A) AMOUNTS CONSIDERED AS DISTRIBUTIVE SHARES.—Any amount considered under paragraph (1)(A) as a distributive share of partnership income shall be taken into account by the partnership and by the recipient as of the last day of the partnership taxable year with respect to which such amount is determined.

"(B) AMOUNTS CONSIDERED AS GUARANTEED PAYMENTS.—Any amount considered under paragraph (1)(B) as a guaranteed payment shall be taken into account by the partnership and by the recipient as of the last day of the partnership taxable year in which such amount was paid or payable.

"(b) AMOUNTS CONSIDERED AS DISTRIBUTIONS.—

"(1) GENERAL RULE.—Amounts payable in liquidation of the interest of a retiring partner or a deceased partner shall be considered as payable in a distribution by the partnership, and not as a distributive share or guaranteed payment under subsection (a), to the extent that, under regulations prescribed by the Secretary or his delegate, such amounts (other than amounts described in paragraph (2)) are attributable to the interest of such partner in partnership property.

"(2) AMOUNTS NOT CONSIDERED AS COMING UNDER SUBSECTION.—For purposes of this subsection, amounts attributable to an interest in partnership property shall not include amounts payable with respect to—

"(A) unrealized receivables of the partnership (as defined in subsection (c)(4)), or

"(B) goodwill of the partnership, except to the extent the partnership agreement provides for a payment with respect to goodwill.

"(c) RULES FOR APPLICATION OF SECTION.—

"(1) EXCEPTION WHERE ALL AMOUNTS ARE PAYABLE IN 12-MONTH PERIOD.—If all amounts payable in liquidation of an interest in a partnership are payable within a 12-month period, such amounts shall be considered as a distribution by the partnership, and subsections (a) and (b) shall not apply.

"(2) AMOUNTS PAID IN MONEY AND OTHER PROPERTY.—Where amounts paid in liquidation of a partner's interest are amounts to which both subsection (a) and subsection (b) are applicable and are amounts paid both in money and in other property, such money shall first be deemed to be in payment for the amount to which subsection (a) is applicable, and only to the extent such money is in excess of such amount shall it be deemed to be part of the amount to which subsection (b) is applicable.

"(3) SECTION 776(a) AMOUNTS PAID AFTER TERMINATION OF PARTNERSHIP.—If upon termination of a partnership any person continues to pay amounts in liquidation of the interest of a retiring partner or deceased partner to which subsection (a) was applicable—

"(A) The retiring partner, or successor in interest of the deceased partner, shall include in gross income under section 61(a) (as amounts having the same character as if subsection (a)(1)(B) of this section applied) any such amounts received from such person.

"(B) If the person making such payment—

"(i) is an individual,

"(ii) was a partner of the partnership immediately before the retirement or death,

"(iii) is under a binding legal obligation to make such payment, and

"(iv) is operating a trade or business as a sole proprietor

then such individual shall be entitled to deduct as a trade or business expense under section 162(a) such amounts which are paid or accrued.

"(4) UNREALIZED RECEIVABLES.—For purposes of this section, the term 'unrealized receivables' means, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payments for—

"(A) goods produced (or delivered, in the case of a partnership predominantly engaged in a distributing trade or business), to the extent that the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

"(B) services rendered.

"SEC. 777. CROSS REFERENCES RELATING TO PARTNERSHIP INCOME TREATED AS INCOME IN RESPECT OF DECEDENT AND EXCEPTION AS TO APPLICATION OF RULE FOR PROPERTY ACQUIRED FROM A DECEDENT.

"(1) For treatment of partnership income for portion of year before death of partner, see section 691(e)(1).

"(2) For treatment of section 776(a) amounts, see section 691(e)(2).

"(3) For treatment on death of partner of unrealized receivables not included in section 776(a) amounts, see section 691(e)(3).

"(4) For treatment of amounts includible in the income of a successor in interest where a partnership capital interest was exchanged for services, see section 691(e)(4).

"(5) For rule excepting from the application of section 1014(a) (relating to basis of property acquired from a decedent) a portion of partnership interest acquired from deceased partner, see section 1014(c).

"Subpart D—Special Adjustments to Basis of Partnership Property

"Sec. 780. Manner of electing optional adjustments to basis of partnership property.
"Sec. 781. Optional adjustment in case of distribution of property.
"Sec. 782. Optional adjustment in case of transfer of interest.
"Sec. 783. Allocation of basis for optional adjustments.
"Sec. 784. Special basis to transferee upon subsequent distribution.
"Sec. 785. Special basis to transferee upon subsequent sale or exchange.

"SEC. 780. MANNER OF ELECTING OPTIONAL ADJUSTMENTS TO BASIS OF PARTNERSHIP PROPERTY.

"If a partnership—

"(1) files an election with respect to distributions of property, the basis of partnership property shall be adjusted in the manner provided in section 781 with respect to all distributions, or

"(b) SALE OR LIQUIDATION OF INTEREST OF A PARTNER.—

"(1) DISPOSITION OF ENTIRE INTEREST.—Except as provided in subsection (a), the taxable year of a partnership shall close—

"(A) with respect to a partner who sells or exchanges his entire interest in a partnership, and

"(B) with respect to a partner whose interest is liquidated.

Such partner's distributive share of items described in section 702 (a) or (c) for such year shall be determined, under regulations prescribed by the Secretary or his delegate, for the period ending with such sale, exchange, or liquidation.

"(2) DISPOSITION OF LESS THAN ENTIRE INTEREST.—Except as provided in subsection (a), the taxable year of a partnership shall not close (other than at the end of a partnership's taxable year) with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced, but such partner's distributive share of items described in section 702 (a) or (c) shall be determined by taking into account his varying interests in the partnership during the taxable year.

"(c) CROSS REFERENCE.—

"For general rule for the closing of a partnership taxable year, see section 706(c).

"SEC. 765. CERTAIN SALES OR EXCHANGES OF PROPERTY WITH RESPECT TO CONTROLLED PARTNERSHIPS.

"(a) LOSSES DISALLOWED.—No deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between—

"(1) a person and a partnership in which more than 50 percent of the capital interest, or the profits interest, is owned by such person,

"(2) two partnerships in which the same person or persons own common interests of more than 50 percent of the capital interests or profits interests,

"(3) a partnership and a corporation in which the same person or persons own common interests of more than 50 percent of the capital interest, or profits interest, of the partnership and of the value of the outstanding stock of the corporation, or

"(4) a partnership and a trust or estate in which the same person or persons own common interests of more than 50 percent of the capital interest, or profits interest, of the partnership and of the value, actuarially computed, of the trust or estate.

"(b) GAINS TREATED AS ORDINARY INCOME.—In the case of a sale or exchange, directly or indirectly, of property which in the hands of the transferee is neither a capital asset as defined in section 1221 nor land used in the trade or business—

"(1) between a person and a partnership in which more than 80 percent of the capital interest, or profits interest, is owned by such person, or

"(2) between two partnerships in which the same person or persons own common interests of more than 80 percent of the capital interests or profits interests,

any gain recognized shall be considered as gain from the sale or exchange of property other than a capital asset.

"(c) APPLICATION OF SECTION 267.—

"(1) SECTION 267(a)(1) INAPPLICABLE.—Section 267(a)(1) shall not apply to any sale or exchange between a person and a partnership, between two partnerships, or between a partnership and a corporation, a trust, or an estate.

"(2) APPLICATION OF CONSTRUCTIVE OWNERSHIP RULES PROVIDED IN SECTION 267(c).—For purposes of subsections (a) and (b), the ownership of an interest in a partnership, trust, or estate, or of stock in a corporation, shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) other than paragraph (3) of such subsection.

"(3) APPLICATION OF SECTION 267(d).—If a loss was disallowed under subsection (a), in the case of a subsequent sale or exchange by a transferee described in subsection (a) section 267(d) shall be applicable as if the loss had been disallowed under section 267(a)(1).

"(d) MEANING OF COMMON INTERESTS.—Where one or more persons hold an interest in two organizations between which, directly or indirectly, there is a sale or exchange of property, the common interests of such person or persons

in such organizations for purposes of subsections (a) and (b) shall be the sum of the smaller interests held by such person or each of such persons in such organizations. For purposes of this subsection, an interest in an organization shall include an interest in the capital or profits (whichever proportion is larger) of a partnership, the holding of outstanding stock in a corporation, and the beneficial interests, actuarially computed, in a trust or estate.

"(e) CROSS REFERENCE.—

"For general rules applicable in the case of transactions between partner and partnership, see section 707.

"SEC. 766. CONTINUING PARTNERSHIP IN MERGERS OR CONSOLIDATIONS AND DIVISIONS.

"(a) MERGER OR CONSOLIDATION.—In the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of section 708(a), be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

"(b) DIVISION OF A PARTNERSHIP.—In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) shall, for purposes of section 708(a), be considered a continuation of the prior partnership.

"(c) CROSS REFERENCE.—

"For general rules applicable in determining a continuing partnership, see section 708.

"Subpart B—Interest in Partnership Capital Exchanged for Services

"Sec. 770. Interest in partnership capital exchanged for services.

"SEC. 770. INTEREST IN PARTNERSHIP CAPITAL EXCHANGED FOR SERVICES.

"(a) TREATMENT OF PERSON PERFORMING SERVICES.—If a person receives an interest in the capital of a partnership in exchange for the performance of services for the partnership—

"(1) the amount determined under subsection (c) shall be included in such person's gross income, and

"(2) an amount equal to such amount shall be deemed to be a contribution by such person to the partnership.

"(b) TREATMENT OF PARTNERSHIP AND OF PARTNER RELINQUISHING INTEREST.—If any partner reliquishes an interest in the capital of a partnership in exchange for the performance of services for such partnership, no gain or loss shall be recognized to such partner on the relinquishment and, with respect to the amount determined under subsection (c)—

"(1) the partnership shall be allowed a deduction, to the extent such amount constitutes a trade or business expense (described in section 162(a)) to the partnership, and

"(2) the adjusted basis of the partnership properties shall be increased (in accordance with the services performed with respect to each), to the extent such amount constitutes an amount properly chargeable to capital account under section 1016(a)(1).

Any deduction allowable under paragraph (1) shall be allocated among the relinquishing partners (or their successors in interest) on the basis of that portion of such deduction which is attributable to each such partner.

"(c) AMOUNT TO BE TAKEN INTO ACCOUNT; TIME WHEN TAKEN INTO ACCOUNT.—

"(1) IN GENERAL.—Except as provided in paragraph (2), for purposes of subsections (a) and (b) the amount determined under this subsection—

"(A) if the interest, at the time of the exchange, is not subject to substantial restrictions or limitations as to its transferability, shall be taken into account at the time of the exchange, and shall be the fair market value of the interest at such time, or

"(B) if the interest, at the time of the exchange, is subject to substantial restrictions or limitations as to its transferability, shall be taken into account at the time such restrictions or limitations cease

"(2) files an election with respect to transfers of partnership interests, the basis of partnership property shall be adjusted in the manner provided in section 782 with respect to all such transfers,

during the taxable year for which such election is filed and all subsequent taxable years. Either such election may be filed, or changed, at any time prior to the expiration of 1 year after the time prescribed by law for the filing of the partnership return for the taxable year for which such election was filed, not including any extension of such time. An election filed under either paragraph (1) or (2) may be revoked by the partnership, subject to such limitations as may be provided by regulations prescribed by the Secretary or his delegate.

"SEC. 781. OPTIONAL ADJUSTMENT IN CASE OF DISTRIBUTION OF PROPERTY.

"(a) METHOD OF ADJUSTMENT.—In the case of a distribution of property to a partner, a partnership with respect to which the election provided in section 780(1) is in effect shall—

"(1) increase the adjusted basis of partnership property by the excess of the adjusted basis to the partnership of the property distributed over the reduction, as a result of the distribution, in the distributee partner's proportionate share of the adjusted basis of the partnership property, or

"(2) decrease the adjusted basis of partnership property by the excess of the reduction, as a result of the distribution, in the distributee partner's proportionate share of the adjusted basis of the partnership property over the adjusted basis to the partnership of the property distributed,

except that the partnership shall not make any adjustment with respect to partnership property if the distribution, with respect to which such adjustment would otherwise be made, would result in an upward or downward aggregate adjustment to partnership property of less than $1,000. For purposes of this subsection, a partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital, and the adjusted basis of partnership property shall be determined by taking into account any agreement described in section 761(a) (relating to effect of partnership agreement on contributed property) but without regard to any adjustment (described in section 782) to partnership property with respect to a transferee partner only.

"(b) ALLOCATION OF BASIS.—The allocation of basis among partnership properties where subsection (a) is applicable shall be made in accordance with the rules provided in section 783.

"(c) CROSS REFERENCE.—

"For general rule as to adjustment to basis of partnership property upon a distribution, see section 734.

"SEC. 782. OPTIONAL ADJUSTMENT IN CASE OF TRANSFER OF INTEREST.

"(a) ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.—In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 780(2) is in effect shall—

"(1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or

"(2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership

except that the partnership shall not make any adjustment with respect to partnership property if the transfer, with respect to which such adjustment would otherwise be made, would result in an upward or downward aggregate adjustment to partnership property of less than $1,000. Under regulations prescribed by the Secretary of his delegate, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital and, in the case of an agreement described in section 761(a) (relating to effect of partnership agreement on contributed property), such share shall be determined by taking such agreement into account. In the

case of an adjustment under this subsection to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for the transferee partner with respect to his interest in such property.

"(b) ALLOCATION OF BASIS.—The allocation of basis among partnership properties where subsection (a) is applicable shall be made in accordance with the rules provided in section 783.

"(c) CROSS REFERENCE.—

"For general rule as to adjustment to basis of partnership property upon a transfer of an interest, see section 743.

"SEC. 783. ALLOCATION OF BASIS FOR OPTIONAL ADJUSTMENTS.

"(a) GENERAL RULE.—Any increase or decrease in the adjusted basis of partnership property under section 781 (relating to the optional adjustment to the basis of undistributed partnership property) or section 782 (relating to the optional adjustment to the basis of partnership property in the case of a transfer of an interest in a partnership) shall, except as provided in subsection (b), be allocated—

"(1) in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties, or

"(2) in any other manner permitted by regulations prescribed by the Secretary or his delegate.

"(b) SPECIAL RULES.—

"(1) ALLOCATIONS ARISING FROM DISTRIBUTIONS TO BE SEPARATED INTO TWO CATEGORIES.—In applying the allocation rules provided in subsection (a), increases or decreases in the adjusted basis of partnership property arising from a distribution attributable to property consisting of—

"(A) capital assets and property described in section 1231(b), or

"(B) any other property of the partnership,

shall be allocated to partnership property of a like character. If the adjustment to basis of property described in subparagraph (A) or (B) is prevented by the absence of such property or by insufficient adjusted basis for such property, such adjustment shall be applied to subsequently acquired partnership property of a like character in accordance with regulations prescribed by the Secretary or his delegate.

"(2) CERTAIN ADJUSTMENTS NOT TO BE MADE.—In applying the allocation rules in subsection (a) or in paragraph (1) of this subsection, the adjusted basis of any partnership property shall not be reduced below zero nor increased above its fair market value.

"SEC. 784. SPECIAL BASIS TO TRANSFEREE UPON SUBSEQUENT DISTRIBUTION.

"For purposes of section 732, a partner who acquired all or a part of his interest by a transfer with respect to which the election provided by section 780(2) is not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within 2 years after such transfer, may elect, under regulations prescribed by the Secretary or his delegate, to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided by section 782 were in effect with respect to the partnership property. The Secretary or his delegate may by regulations require the application of this section in the case of a distribution to a transferee partner, whether or not made within 2 years after the transfer, if at the time of the transfer the fair market value of the partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

"SEC. 785. SPECIAL BASIS TO TRANSFEREE UPON SUBSEQUENT SALE OR EXCHANGE.

"For purposes of determining the partnership basis allocable under section 749 to section 751 assets, a partner—

"(1) who acquired all or a part of his interest by a transfer with respect to which the election provided by section 780(2) is not in effect, and

"(2) who, within 2 years after such prior transfer, sells or exchanges an interest in the partnership to which section 740 is applicable,

may elect, under regulations prescribed by the Secretary or his delegate, to treat as the adjusted basis of the section 751 assets attributable to such prior transfer the adjusted basis such assets would have if the adjustment provided by section 782 were in effect with respect to such prior transfer.

"PART IV—DEFINITIONS

"Sec. 788. Terms defined.

"SEC. 788. TERMS DEFINED.

"(a) PARTNERSHIP.—

"(1) DEFINITION OF PARTNERSHIP.—For purposes of this subtitle, the term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation.

"(2) ORGANIZATIONS EXCLUDED.—Under regulations prescribed by the Secretary or his delegate, the Secretary or his delegate may, at the election of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of—

"(A) for investment purposes only and not for the active conduct of a business, or

"(B) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted,

if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

"(b) PARTNER.—For purposes of this subtitle, the term 'partner' means a member of a partnership.

"(c) PARTNERSHIP AGREEMENT.—For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

"(d) LIQUIDATION OF A PARTNER'S INTEREST.—For purposes of this subchapter, the term 'liquidation of a partner's interest' means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership."

SEC. 202. INCOME IN RESPECT OF A DECEDENT.

Section 691 (relating to income in respect of a decedent) is amended by striking out subsection (e) and by inserting in lieu thereof the following new subsection:

"(e) CERTAIN SPECIFIC RULES FOR PARTNERS AND PARTNERSHIPS.—For purposes of this section, the following are items of gross income in respect of a decedent:

"(1) SHARE OF PARTNERSHIP INCOME FOR PORTION OF YEAR BEFORE DEATH.—Where the partnership taxable year with respect to a deceased partner closes after the date of his death, the amount of his distributive share of items of income and gain described in section 702(a) or (e) attributable to the portion of such taxable year ending on the date of his death.

"(2) SECTION 776(a) AMOUNTS.—Any amounts includible under section 776(a) (relating to amounts considered as distributive shares or guaranteed payments) in the gross income of a successor in interest of a deceased partner.

"(3) UNREALIZED RECEIVABLES.—Amounts includible in the gross income of a successor in interest of a deceased partner which are attributable to the decedent's interest in partnership income of the type described in section 776(c)(4) (defining unrealized receivables), to the extent not so considered under paragraph (2).

"(4) PARTNERSHIP CAPITAL INTEREST RECEIVED FOR SERVICES.—The amount required to be taken into account under section 770(a) (relating to interest in partnership capital received for services), determined as if section 770(c)(2) applied, where the interest is acquired by a successor in interest by reason of death and where the substantial restrictions or limitations continue beyond such death. Notwithstanding any other provision of this section, such amount shall be taken into account for purposes of this section at the time the restrictions or limitations cease to be substantial or the interest is transferred (within the meaning of subsection (a)(2) of his section), whichever first occurs."

SEC. 203. TECHNICAL AMENDMENTS.

(a) Section 170(d)(2)(A) (relating to the definition of the term "purchase" for purposes of the additional first-year depreciation allowance for small business) is amended by striking out "or 707(b)" and inserting in lieu thereof "or 765".

(b) Section 901(d)(2) (relating to certain cross references in the case of taxes of foreign countries and of possessions of United States) is amended by striking out "section 703(b)" and inserting in lieu thereof "section 703(c)".

(c) Section 1014(c) (relating to basis of property acquired from a decedent) is amended to read as follows:

"(c) PROPERTY REPRESENTING INCOME IN RESPECT OF A DECEDENT.—Subsections (a) and (b) shall not apply to—

"(1) property which constitutes a right to receive an item of income in respect of a decedent under section 691; and

"(2) that portion of the value of an interest in a partnership attributable to property which constitutes a right to receive an item of income in respect of a decedent under section 691."

(d) Section 1223(10) (relating to certain cross references in the case of holding period of property) is amended by striking out "section 735(b)" and inserting in lieu thereof "section 736".

(e) Section 1375(c) (relating to treatment of distributions to a member of a family group in the case of election of certain small business corporations as to taxable status) is amended by striking out "section 704(e)(3)" and inserting in lieu thereof "section 762(c)".

(f) Section 1402(a)(iii) and (iv) (relating to the definition of net earnings from self-employment) is amended by striking out "section 707(c)" both places it appears and inserting in lieu thereof "section 707(b)". Section 1402(a) is amended by adding at the end thereof the following new sentence: "In the case of a partnership taxable year with respect to which an election described in section 702(e) (relating to simplified reporting for income from a partnership) is applicable, references in this subsection to section 702(a)(9) shall be treated as references to section 702(e)(1)(B)."

(g) Section 4383(a) (relating to certain changes in partnerships affecting the application of documentary stamp taxes) is amended by striking out "section 708" and inserting in lieu thereof "section 708 or 766".

(h) Section 6031 (relating to return of partnership income) is amended by striking out "section 761 (a))" and inserting in lieu thereof "section 788(a))".

SEC. 204. EFFECTIVE DATES.

(a) GENERAL RULE.—Except as otherwise provided in this title, the amendments made by this title shall apply with respect to—

(1) any partnership taxable year beginning on or after the date of enactment of this Act, and

(2) any part of a partner's taxable year falling within such partnership taxable year.

(b) SPECIAL RULES FOR CERTAIN NEW SUBCHAPTER K PROVISIONS.—The following provisions of the Internal Revenue Code of 1954 (as contained in the amendment made by section 201 of this Act) shall take effect as follows:

(1) Section 735 (relating to character of gain or loss on disposition of distributed section 751 assets) shall apply only if the distribution of the assets by the partnership took place in a partnership taxable year beginning on or after the date of the enactment of this Act.

(2) Section 764 (relating to closing of partnership taxable year for deceased partner or partner who sells or exchanges part or all of his interest) shall apply only to a partner who dies, or sells or exchanges part or all of his interest, as the case may be, on or after January 1, 1960, whether or not the taxable year of the partnership begins before, on, or after such date.

(3) Section 765 (relating to certain sales or exchanges of property with respect to controlled partnerships) shall apply only if the loss described in section 765(a) or the gain described in section 765(b) arose from a sale or exchange occurring on or after the date of the enactment of this Act in a taxable year ending on or after such date.

(4) Section 770 (relating to interest in partnership capital exchanged for services) shall apply only in respect of exchanges described in such section

occurring during any partnership taxable year beginning on or after the date of the enactment of this Act.

(5) Section 776 (relating to amounts paid to a retired partner or a deceased partner's successor in interest) shall apply only in respect of partners who die or retire during any partnership taxable year beginning on or after the date of the enactment of this Act.

(c) SPECIAL RULES FOR AMENDMENTS TO SECTIONS 691 AND 1014.—Section 691(e) (as amended by section 202 of this Act), and section 1014(c) (as amended by section 203(c) of this Act), of the Internal Revenue Code of 1954 shall apply only in respect of decedents dying during any partnership taxable year beginning on or after the date of the enactment of this Act.

SEC. 205. OTHER APPLICABLE RULES.

(a) ELECTIONS UNDER PRIOR LAW AS TO OPTIONAL ADJUSTMENTS TO BASIS.—In the case of any election under section 754 of the Internal Revenue Code of 1954 (as in effect before the amendment made by section 201 of this Act), such election shall be treated as an election made under paragraph (1), and as an election made under paragraph (2), of section 780 of the Internal Revenue Code of 1954 (as amended by section 201 of this Act); except that the election so treated may, without the consent of the Secretary of the Treasury or his delegate, be revoked with respect to such paragraph (1) or such paragraph (2) (but not both). Any revocation under the preceding sentence may be made at any time prior to the expiration of one year after the time prescribed by law for the filing of the partnership return for the first taxable year of the partnership beginning on or after the date of enactment of this Act (not including any extension of such time), but shall not affect any taxable year of the partnership prior to such first taxable year.

(b) CONTINUATION OF CERTAIN PROVISIONS OF PRIOR LAW DURING TRANSITIONAL PERIOD.—The provisions of the Internal Revenue Code of 1954 (as in effect before the enactment of this Act) shall continue to apply with respect to transactions for which rules are provided in the amendments made by this title until such rules take effect.

(c) CERTAIN TRANSITIONAL RULES.—For purposes of the application of sections 7851 and 7852 of the Internal Revenue Code of 1954, any reference in such sections to the Internal Revenue Code of 1939 shall where not otherwise manifestly incompatible with the intent of this title, be deemed to include a reference to the provisions of the Internal Revenue Code of 1954 as in effect before the enactment of this Act.

Passed the House of Representatives February 4, 1960.

Attest:

RALPH R. ROBERTS, *Clerk.*

Summary of Partnership Provisions in H.R. 9662, Trust and Partnership Income Tax Revision Act of 1960

I. GENERAL STATEMENT

This bill is concerned with the revisions of two subchapters of chapter 1 of the Internal Revenue Code. These are subchapter J, which deals with the income tax treatment of estates, trusts, and beneficiaries, and subchapter K, which deals with the income tax treatment of partners and partnerships. The estate and trust tax provisions appear in title I of the bill and those relating to partners and partnerships in title II.

The work on these subchapters began with advisory groups established on November 28, 1956, by a subcommittee of the Ways and Means Committee. The reports of the advisory groups were completed by the end of 1958 and hearings were held on bills arising from these reports in February and March of 1959. The bulk of the advisory groups' recommendations both in the case of subchapter J and subchapter K have been incorporated in this bill, although there are important differences.

Among the more important estate and trust provisions is the one relating to multiple trusts, which is designed to prevent tax avoidance. Where separate trusts, created by the same grantor, distribute income accumulated over a number of years to the same beneficiary, the splitting of the income into several taxable entities results in taxation at lower rates than otherwise would be the case and reduces the overall tax burden. To prevent the use of multiple trusts to achieve this effect the bill in general taxes distributions from them to the beneficiaries at the time they are received, to the extent that income has been accumulated in the preceding 10 years.

Another important provision also designed to prevent income from escaping taxation relates to the sale of property subject to legal life estates or other terminable legal interests. In these cases the bill deems a trust to exist with respect to the gross income derived from property subject to a terminable legal interest, where the income is not taxable to the holder of the interest or to any other person but would be taxable if a trust existed.

Another important change relates to the so-called tier system which establishes an order of priority to determine which distribution to beneficiaries from estates and trusts are to be deemed to consist of income and which are not. This problem arises because the amount distributed by the estate or trusts may be in excess of its income for the current year. Present law contains a two-tier system. The bill removes hardships which have arisen under this by establishing a three-tier system under which all beneficiaries who can receive distributions only out of the income are placed in the first tier, those who can receive distributions of either income or corpus are placed in the second tier, and those who can receive distributions only of corpus are placed in the third tier.

Another important change relates to the treatment accorded charitable contributions of trusts. The bill, as a simplification measure,

treats these contributions as distribution deductions rather than as deductions from gross income as is provided by present law. To eliminate opportunities for tax avoidance, the bill also provides a special rule under which noncharitable beneficiaries must include in their income all amounts distributed to the extent of the distributable net income of the estate or trust, unreduced by any distributions to charity by the estate or trust.

The bill also revises the rules of present law excluding from taxation distributions of gifts and bequests of specific sums of money or as specific property, and extends the application of the separate share rule (now applicable only to trusts) to estates.

The changes made in the estate and trust provisions are described in greater detail below.

II. GENERAL EXPLANATION OF PROVISIONS RELATING TO ESTATES AND TRUSTS

1. Section 641(c). Terminable legal interests (sec. 111(a) of bill)

Under certain court decisions it is possible that gain from the sale or exchange of property by a person who owns a legal life estate in such property may completely escape taxation. In *Cooke* v. *U.S.* (115 F. Supp. 830, aff'd 228 F. 2d 667 (9th Cir., 1955)), a spouse was given a legal life estate in certain stocks with the right to the income for her life, without liability for waste, and the legal remainder in the property was given to the surviving children. The securities were redeemed in a liquidation and a large gain was realized. The court held that the gain was not taxable to the life tenant since she was not a fiduciary and was only entitled to the income.

The bill adds a new provision to the code to deal with this problem. Under the bill, a trust will be deemed to exist for the calendar year with respect to that gain and the person holding the legal life estate or other terminable legal interest will be deemed to be a fiduciary of the trust and will be required to report the gain and pay the appropriate tax.

The operation of the new provision may be illustrated as follows: A transfers shares of stock to B, for life, with B entitled to all the income. At B's death, the stock, or property substituted by B therefor, is to go to the children of B who survive B. B has the power to alter the nature of the property underlying the life estate, by sale or by purchase, but is entitled in any event only to the income from the property. If B sells the property at a gain, and the gain is not currently includible in the gross income of any person, but such gain would be currently includible in the income of a trust, if one existed, the gain will be deemed held in trust for the calendar year. If no distribution of the gain is made or required to be made, B (as trustee) will be required to pay the tax due on the gain.

2. Section 641(a)(2). Income collected by guardian (sec. 101(b) of bill)

Inasmuch as income collected by a guardian of an infant is not taxable under subchapter J (relating to estates, trusts and beneficiaries), the bill strikes from this section of existing law the material therein referring to the guardian of an infant.

3. Section 642(a)(3). Dividend exclusion (sec. 102(a) of bill)

Present law excludes from gross income certain dividends received to the extent that the dividends do not exceed $50. Present law also provides that amounts which are paid, credited or required to be distributed currently to a beneficiary shall have the same character in the hands of the beneficiary as in the hands of the estate or trust.

Under present law, distributions of dividends by an estate or trust are deemed to consist of a ratable part of the $50 of excluded dividends, so that if, for example, the estate or trust receives $1,000 of dividends

and distributes $500 of dividends to beneficiaries, the estate or trust will be entitled to exclude only $25 of the undistributed dividends.

The bill amends present law to provide that in determining whether an estate or trust is entitled to the dividend exclusion, any amount of qualifying dividends allocable to a beneficiary shall be allocable first from the qualifying dividends which are not excluded from gross income, i.e., the estate or trust shall be entitled to the $50 dividend exclusion to the extent that the estate or trust retains qualifying dividends. For example, if the distributable net income of an estate or trust includes $1,000 of dividends which qualify for the exclusion, and the part of such dividends deemed distributed to beneficiaries amounts to $950, so that $50 of such dividends will be deemed not distributed, the estate or trust will be entitled to exclude the entire $50 from gross income. If in such case the amount of qualifying dividends deemed distributed to beneficiaries is $975, the estate or trust will be entitled to exclude the balance of $25 from gross income.

4. Section 642(c). Charitable deduction (sec. 102(b) of bill)

Under present law an estate or trust is allowed an unlimited deduction for any amount of gross income paid or permanently set aside or used exclusively for a charitable, etc., purpose. An estate or trust is also allowed a deduction for distributions to noncharitable beneficiaries. Charitable contributions are allowed under present law as a deduction from "gross income" in computing taxable income, whereas the deduction for distributions to a noncharitable beneficiary is allowed as a distribution deduction.

In order to simplify the law and to eliminate the necessity for numerous complicating adjustments, and to simplify the administration of trusts and estates, the bill amends subchapter J to provide that amounts paid to, set aside for, or used for charitable, etc., purposes by trusts and estates be treated as distribution deductions rather than as deductions from gross income.

5. Section 642(e). Deduction for depreciation and depletion (sec. 102(c) of bill)

This is a clarifying amendment to make it clear that a portion of any depreciation or depletion allowances to which a trust or estate is entitled should be allocated to charitable as well as noncharitable beneficiaries.

6. Section 642(h). Carryovers on termination (sec. 102(d) of bill)

Upon the final termination of an estate or trust, present law permits the beneficiaries who succeed to the property of the trust to deduct a proportionate share of any unused net operating loss carryover, unused capital loss carryforward, and other excess deductions of the estate or trust.

Since the provision applies only to final terminations, none of the specified items of deduction are available to a beneficiary where there is a termination of such beneficiary's entire interest in the estate or trust but the estate or trust continues for other beneficiaries.

The bill makes the provisions of present law applicable on the termination of a single beneficiary's entire interest in an estate or trust having more than one beneficiary where such interest constitutes a separate share by treating separate and independent shares of beneficiaries in a trust or estate as separate trusts or estates. To

prevent double deductions, the bill would bar the use by the continuing trust of that portion of the excess deductions and carryovers allocated to such a beneficiary.

7. Section 642(i). Deduction for estate tax (sec. 102(e) of bill)

This is a clarifying amendment to make clear that an estate or trust is allowed a deduction for its appropriate share of the estate taxes paid on income in respect of a decedent (i.e., item included in the gross estate of a decedent for estate tax purposes and in income of the decedent's successor for income tax purposes). The balance of the deduction would be allowable to the beneficiaries to whom the remaining income in respect of a decedent is allocable.

8. Section 643(a)(2). Deduction for estate tax (sec. 103(a) of bill)

The bill makes it clear that in computing distributable net income the deduction for estate taxes attributable to income in respect of a decedent which has been distributed to beneficiaries of the estate or trust is not allowed to the estate or trust.

9. Section 643(a)(3)(A). Conforming amendment (sec. 103(b) of bill)

This amendment is a conforming amendment required to carry out the proposed treatment of charitable beneficiaries.

10. Section 643(a)(3)(B). Rules for determining when capital gains are paid (sec. 103(b) of bill)

Capital gains allocated to corpus (i.e., principal of the estate or trust) are included in distributable net income of the estate or trust and are taxable to the beneficiaries to the extent that they are paid, credited, or required to be distributed to the beneficiaries during the taxable year. The present statute leaves uncertain whether a distribution of corpus of the estate or trust will be deemed to include capital gains realized by the estate or trust during the same taxable year. For example, if a fiduciary sells property at a gain and deposits the proceeds in a bank account in which are held funds constituting principal and makes a distribution from that account during the taxable year, it is not clear whether the distribution is to be deemed to include all or a part of the capital gains.

The bill amends present law to provide that capital gains shall not be considered paid, credited, or required to be distributed (and therefore will be excluded from distributable net income) unless at least one of the following requirements is met: (1) they are required to be distributed currently under the governing instrument or local law; (2) they are not required to be distributed currently, but the books of the fiduciary or notice to the beneficiary shows an intention to pay or credit such amounts to the beneficiary during the taxable year; (3) the fiduciary follows the regular practice of distributing all capital gains; (4) the capital gains are received in the year of termination of the estate or trust, or (5) the capital gains are received in the year of termination of an entire separate share of an estate or trust.

For example, if an executor sells property for $10,000 realizing a gain of $2,000, and deposits the proceeds of sale in a commingled bank account, and distributes $5,000 from the account to a beneficiary, the distribution will not be considered to include any part of the capital gain if none of the five enumerated requirements is met. On the other hand, if the fiduciary issues a check on the commingled account for $2,000 payable to a named beneficiary and makes an entry on

his books showing that the check is a distribution of capital gain or so notifies the beneficiary, the distribution will be considered a distribution of capital gain.

11. Section 643(a)(3)(C). Deductions against corpus (sec. 108(b) of bill)

Under present law all deductible charges against an estate or trust, whether paid from income or from corpus (i.e., principal), are allowed as deductions in computing distributable net income, so that the primary benefit of the deductions inures to the income beneficiaries. Only to the extent that such deductions exceed distributable net income are they allowed to offset income allocated to corpus and taxable to the trust. Hence, even where the deductions are properly chargeable against corpus and borne by the remaindermen, they are allowed by present law to benefit first the income beneficiaries and thus, in many instances the remaindermen are improperly deprived of tax deductions.

The bill provides that deductions chargeable to corpus shall first be applied against income which is allocable to corpus and taxable to the trust or estate. This amendment allows the benefit of such deductions first to the corpus beneficiaries who ultimately bear the tax burden. Only the excess of such deductions which the trust cannot use to offset income allocated to corpus is permitted to reduce distributable net income for the benefit of the income beneficiaries. If the alternative method under section 1201 is used in computing the tax on capital gains, the deductions chargeable to corpus otherwise available are not permitted to reduce distributable net income for the benefit of the income beneficiaries.

12. Section 643(a)(6). Foreign estates (sec. 108(c) of bill)

Present law provides for the inclusion in distributable net income of items of foreign income of foreign trusts. This inclusion is necessary in the determination of the tax liability of a beneficiary subject to U.S. tax. A similar rule in the case of foreign income of a foreign estate is provided by the bill.

13. Section 643(a). Conforming amendment (sec. 108(d) of bill)

This is a conforming amendment in connection with the proposed change in treatment of charitable contributions by estates and trusts.

14. Section 643(b). Definition of income (sec. 108(e) of bill)

This change merely clarifies existing law by adding capital gains to the items which are not to be considered income for purposes of the provisions distinguishing between income and corpus when under the terms of the governing instrument and applicable local law they are allocable to corpus.

15. Section 643(c). Clerical amendment (sec. 108(f) of bill)

This amendment is a clerical amendment.

16. Section 643(d). Charitable beneficiary defined (sec. 108(g) of bill)

The bill adds a definition of the term "charitable beneficiary" in connection with the treatment by the bill of distributions to such beneficiaries as distribution deductions. Under the amendment, an organization qualifying as a charitable donee under present law qualifies as a charitable beneficiary for purposes of the subchapter on estates, trusts, and beneficiaries.

17. Section 651(a). Simple trusts (sec. 104 of bill)

The bill conforms this provision of present law to reflect the treatment of charitable beneficiaries provided by the bill.

18. Section 651(b). Limitation on deduction (sec. 104 of bill)

The bill amends present law to make it clear that in the computation of "distributable net income" and "income required to be distributed currently" both (and not just the former) must be reduced by all items of income which are not included in the gross income of the trust for purposes of determining the amount of the distribution deduction of the trust. The amendment also makes it clear that the character of such items is to be determined by reference to the rules in section 652(b).

19. Section 652(b). Clarifying amendment (sec. 105(a) of bill)

The bill makes an amendment clarifying existing law by inserting in this provision the words "or applicable local law" in recognition of the fact that local law may specify an allocation of different classes of income to different beneficiaries and that if it does the effect will be the same as if the terms of the trust made such specification.

20. Section 652(c). Different taxable years (sec. 105(b) of bill)

Under existing law, where a beneficiary of a so-called simple trust and the trust have different taxable years, the tax of the beneficiary is measured by the distributable net income of the trust for the taxable year of the trust ending with or within the taxable year of the beneficiary. The language of existing law, however, is not explicit where, for example, because of the death of the beneficiary, there is no taxable year of the trust ending with or within the beneficiary's last taxable year. If, for example, the beneficiary's taxable year is the calendar year and the trust's taxable year is the fiscal year ending June 30, there would be no taxable year of the trust ending with or within the taxable year of the beneficiary if the beneficiary died on June 1.

The bill provides for the determination of the amount of income of a trust which is to be included in the final return of a beneficiary. For this purpose, in computing distributable net income of the trust with respect to the beneficiary, there shall be taken into account his share of the income of the trust for the period from the end of the last preceding taxable year of the trust up to the time of termination of the beneficiary's taxable year, reduced by items properly charged against such share (in the example, for the period from the preceding July 1, to June 1, the date of death of the beneficiary).

21. Section 661(a). Deduction for distributions (sec. 106(a) of bill)

As stated previously, the bill provides that amounts paid to, set aside for, or used for charitable purposes by an estate or trust shall be treated as distribution deductions rather than as a charitable contribution deduction from gross income.

The bill, however, changes the deduction for charitable contributions in important respects. Existing law permits a deduction for charitable contributions only if paid out of gross income. As interpreted by the courts (*Old Colony Trust* v. *Comr.*, 301 U.S. 379 (1937)) the deduction is allowable for charitable distributions from undistributed gross income of prior years, as well as from gross income of

the current year. Under the bill charitable deductions will be permitted for distributions to charity irrespective of the source of the distribution, whether from income or corpus. In addition, charitable contributions under the bill will be limited to the distributable net income of the estate or trust, rather than being limited merely to contributions out of gross income

Further, the charitable contributions deduction is limited by the bill to that portion of distributable net income of the estate or trust which is not absorbed by distributions to noncharitable beneficiaries. The importance of this treatment of charitable distributions lies in its effect on the noncharitable beneficiaries rather than upon the amount of the deduction allowable to an estate or trust and is discussed under the amendment to section 662(a).

The character of amounts distributed to charitable beneficiaries is determined in the same manner as the character of amounts distributed to noncharitable beneficiaries.

The other changes made in section 661(a) are conforming changes to reflect the three-tier system contained in section 662(a) as amended by section 107(a) of the bill.

22. *Section 661(b). Conforming amendment* (*sec. 106(b) of bill*)

These are conforming amendments.

23. *Section 662(a) The tier system—Inclusion by the beneficiary* (*sec. 107(a) of bill*)

Under present law, all amounts distributed by an estate or trust (whether current income, accumulated income, or corpus) are includible in the gross income of the recipients to the extent of distributable net income of the estate or trust. "Distributable net income" is taxable income with certain adjustments.

Where there is more than one beneficiary receiving distributions, it is necessary to determine the order of priority in which distributions to beneficiaries shall be deemed to consist of income distributed by the estate or trust. This is accomplished by a mechanical device known as the "tier system." Present law establishes a "two-tier" system for this purpose. In general, it provides that the distributable net income of the estate or trust is deemed to be paid first to those beneficiaries receiving income required to be distributed currently (first tier), and then, as to any remaining distributable net income, to all other beneficiaries (second tier). Thus, for purposes of allocating estate or trust income, beneficiaries receiving discretionary distributions of income are placed in the same class or tier with those beneficiaries receiving distributions from corpus. As a consequence, if distributions to required income beneficiaries (tier one) do not use up the full amount of distributable net income, a beneficiary who can receive distributions only out of corpus is taxed on a pro rata share of the remaining distributable net income (along with a beneficiary receiving discretionary payments out of income) even if the distributable net income was in fact only sufficient to satisfy the distributions to the income beneficiaries.

The bill establishes a three-tier order of priority for determining the extent to which distributions shall be included in the gross income of beneficiaries having different interests in the income or corpus of the estate or trust. In the first tier are amounts which are required to be distributed out of current income or which, in the discretion of the

fiduciary, may be paid or credited only out of current income. In the second tier are amounts which may be paid or credited either out of current income or out of corpus (including accumulated income of prior years). In the third tier fall all other amounts paid, credited, or required to be distributed during the taxable year.

If the amounts distributed to any class of beneficiaries exceed the distributable net income available to such class, each beneficiary must include such portion of the available distributable net income as the amount received by him bears to the amounts received by all beneficiaries in the same class.

Under present law any distributable net income remaining after an allocation is made to the first tier beneficiaries is allocated to the charitable deduction before being allocated to beneficiaries coming within the second tier. Thus, under present law in the case of a trust which requires the current income to be paid to charity, and an equal amount of corpus to be paid to Y, Y is not taxed on the amount he receives. The bill provides a special rule with respect to the treatment of charitable contributions and charitable beneficiaries. For reasons of simplification and to preclude the possibility of tax avoidance (possible through the designation of distributions to noncharitable beneficiaries as distributions of corpus, and the designation of distributions to charitable beneficiaries as distributions of income) charitable distributions are placed in the equivalent of a fourth tier. The bill accomplishes this by establishing the order of priority for allocating the distributable net income of the trust or estate to beneficiaries, other than charitable beneficiaries. The result is that noncharitable beneficiaries must include in their income all amounts distributed, whether designated as income or corpus, to the extent of distributable net income of the trust or estate, unreduced by any distributions to charity. Thus, if a trust instrument provides that all of its income is to be currently distributed to a charity, and an equal amount of corpus is to be paid to an individual beneficiary, the individual beneficiary would be taxed, under the bill, on the entire distribution up to the extent of the distributable net income.

24. Section 662(b). Character of amounts (sec. 107(a) of bill)

This amendment is a conforming amendment.

25. Section 662(c). Different taxable years (sec. 107(a) of bill)

The bill provides for estates and so-called complex trusts rules relating to different taxable years which are similar to the rules provided for so-called simple trusts. (See the discussion under section 652(c).)

26. Section 663(a)(1). Exclusions—Gifts, bequests, etc. (sec. 108(a)(1) of bill)

Under present law payments of gifts or bequests of specific sums of money or specific property paid or credited all at once or in not more than three installments are not subject to subchapter J.

Under the bill the exclusion with respect to gifts or bequests which are paid or credited all at once is amended to include gifts or bequests which are distributed within 1 taxable year of the estate or trust, provided that the terms of the governing instrument do not require them to be paid in more than 1 taxable year. The three-installment exclusion of existing law has been changed so that the

exclusion applies to all installments, however many there may be, paid before the close of the 36th calendar month which begins after the date of the death of the testator or grantor, provided that under the terms of the governing instrument no installment is required to be distributed after the close of such 36-month period.

Under existing law, the exclusion applies to inter vivos and testamentary trusts as well as to estates. The bill would eliminate inter vivos trusts from the provisions of this exclusion, except for those which, immediately before the grantor's death, were revocable by the grantor acting alone. Such revocable trusts will be subject to the same provisions as trusts created by will.

27. Section 663(a)(2). Distributions in kind (sec. 108(a)(1) of bill)

The present exclusionary provision in section 663(a), discussed above, often results in inequities, particularly with respect to distributions of corpus by estates. For example, distributions of corpus to residuary legatees, payments solely out of corpus to will contestants, and payments out of corpus (e.g., the family car) to widows pursuant to local law may not be excluded by present law. As a result, distributions to beneficiaries from the residue of an estate sometimes result in a beneficiary being taxed with a disproportionate share of income of the estate.

This amendment, in conjunction with the amendments to section 663(c) (relating to the separate share rule), discussed below, and section 662(a) (relating to the tier system), discussed above, is designed to remove such inequities arising under present law. The amendment adopts a "distributions in kind" approach to permit exclusions from the operation of sections 661 and 662 for distributions from an estate of real property or tangible personal property owned by the decedent at the date of his death, which are properly paid in satisfaction of a bequest, share, award, or allowance from the corpus of a decedent's estate before the close of the 36th calendar month which begins after the date of death of the decedent. For example, suppose a testator, after making minor specific bequests, divides the residue of his estate between his wife and a trust to be established for his minor son. Assume the executor of the estate makes a distribution of the family car and the residence to the widow within 36 months following the decedent's death, charges that distribution to her share of the residuary estate, and makes no other distributions during the same year. Under present law, the distribution of the family car and the residence will cause the widow to be taxed on the distributable net income of the estate to the extent of the value of the family car and residence. Under the bill these distributions would not cause the widow to be taxed on the distributable net income of the estate. There being no other distributions during the year, the income of the estate would be taxed to the estate instead of to the widow.

28. Section 663(a)(3). Denial of double deduction, etc. (sec. 108(a)(1) of bill)

The bill broadens the provisions of existing law which are designed to prevent double deductions to prevent a deduction for amounts actually distributed to a charitable beneficiary where a deduction to an estate or trust for a prior year with respect to those amounts was allowed or allowable (or would have been allowable except for certain limitations) because those amounts in the prior year were credited,

required to be distributed, or permanently set aside for a charitable beneficiary.

29. Section 663(c). Separate share rule (sec. 108(b)(1) of bill)

Present law provides that in the case of so-called complex trusts having more than one beneficiary, if such beneficiaries have "substantially separate and independent shares," such shares shall be treated as separate trusts for the purpose of determining the amount of distributable net income taxable to the respective beneficiaries. Since the rule does not apply to estates, distributions to residuary legatees who are only entitled to receive corpus may be taxed as distributions of income. The bill extends the application of the separate share rule to estates and so-called simple trusts.

30. Section 663(d). Required distribution to another trust (sec. 108(c)(1) of bill)

The bill adds a new subsection to provide for allocation of items of income and deduction where a new trust is created out of the assets of an existing trust or trusts in order, for example, to take care of afterborn children. This amendment is complementary to the amendments to section 665 (b)(6) and (e), contained in section 110(c) of the bill.

31. Section 664. In general (sec. 109 of bill)

Present law taxes a person, other than the grantor, as the owner of any portion of a trust over which he has a power exercisable solely by himself to vest corpus or income in himself.

In certain situations where a person other than the grantor has a power to withdraw a limited amount of corpus each year and no withdrawal is made, present law is not clear as to the tax consequences. Likewise, there is doubt under present law as to the extent to which a person with such a power is taxable on capital gains realized by the trust, and what the tax consequences are where a trust provides that a person other than the grantor may withdraw the income of the previous year 1 day after the end of the taxable year.

The bill repeals the present provision and adds a new provision to provide in general for the treatment of a holder of such powers as a beneficiary, rather than as an owner under subpart E of subchapter J.

Under the bill, if a person, other than the grantor, has a power exercisable solely by himself to vest an amount of corpus or income in himself the amount of income or corpus subject to the power (including the amount of income attributable to the corpus) is considered a distribution under section 651 or 661 (regardless of whether or not the power is exercised) and would be taxable to the holder of the power to the extent provided by those sections.

This may be illustrated as follows: A establishes a trust which gives the trustee the discretion to pay the income to W, or accumulate it, and also gives W a power to withdraw $6,000.00 of the corpus each year. If the trustee does not exercise his discretion to pay W income, under present law W will be taxable, in each year that she makes no withdrawal of corpus, on any amount of income attributable to the $6,000.00 of corpus which she can withdraw. Present law is also susceptible to the construction that W will be taxable in each year in which she actually withdraws the $6,000.00 of corpus on only the amount of income attributable to the corpus which she can withdraw.

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Under the bill W will be deemed to have received the $6,000.00 of corpus over which she has the power of withdrawal, whether or not she exercises that power. If the distributable net income of the trust is sufficient, this $6,000.00 of corpus which she can withdraw may cause her to be taxed under the rules of section 662 on the full amount of the $6,000.00 as well as on the income attributable to the $6,000.00.

32. Section 665. The throwback rule (*sec. 110 of bill*)

The throwback rules of present law (secs. 665–668), in general, provide that in any year in which a trust distributes amounts in excess of its distributable net income for the current year, such excess is "thrown back" and treated as having been distributed in the most recent of the last 5 preceding years, and is taxed to the beneficiaries to the extent that distributable net income for any of the 5 prior years was accumulated. The amounts which would have been includible in gross income by the beneficiary in the back years if actual distributions had been made are includible in the income of the beneficiary for the current taxable year, but the tax thereon may not exceed the aggregate of the taxes that would have been payable if the distributions had been made in the prior years. It is not necessary to reopen the back years because a refund is denied the trust and a credit is allowed the beneficiary for the amount of taxes paid by the trust for the prior years.

Section 665(b) of present law makes the throwback provisions inapplicable unless the accumulation distributions of the current year from the trust exceeds $2,000. Section 665(b) of present law also excludes from the operation of the throwback rules the following amounts:

(1) Amounts properly paid or credited to a beneficiary to meet his emergency needs;

(2) Amounts paid or credited as income accumulated for a minor;

(3) Amounts required by the terms of a trust, created before January 2, 1954, to be paid to a beneficiary upon attaining a specified age or ages, provided there are not more than four such distributions and at least 4 years separate each distribution;

(4) Amounts paid as a final distribution of a trust if the last transfer to the trust was made more than 9 years before.

The amendments to the throwback rules made by section 110 of the bill are described below.

(*a*) *Sections 665*(*a*)(*1*) *and 665*(*b*). *Conforming amendment* (*sec. 110 of bill*)

The bill makes conforming changes in these provisions made necessary by the amendments to the tier system and in the treatment of charitable contributions made elsewhere by the bill.

(*b*) *Section 665*(*b*)(*3*). *Amounts payable on a specified date or dates* (*sec. 110*(*b*) *of bill*)

The exclusion from the throwback rules in paragraph (3) of section 665(b) is amended to make it applicable to amounts paid or credited to a beneficiary "upon a specified date or dates," as well as "upon such beneficiary's attaining a specified age or ages."

(c) *Section 665(b)(4). Final distribution—9-year rule (sec. 110(b) of bill)*

Under present law, a final distribution of a trust is excepted from the 5-year throwback rules if "such final distribution is made more than 9 years after the date of the last transfer" to the trust.

The purpose of the 9-year exception in section 665(b)(4) was to exclude final distributions of a trust from the throwback rules without, however, at the same time encouraging the creation of trusts for the purpose of accumulating income and making final distributions within unreasonably short periods. Interpreted literally, a final distribution of accumulated income from $100,000 of corpus originally transferred to a trust more than 9 years ago would subject the entire distribution to the throwback rules if $100 had been added to the trust within the last 9 years. Thus, a small gift from the grantor or any other person to the trust within 9 years prior to the final distribution from the trust might cause the throwback rules to apply.

The bill amends section 665(b)(4) so that the throwback rule will apply only to the extent the final distribution is attributable to property transferred to the trust within the 9 years preceding such distribution, including the income attributable to such property.

(d) *Section 665(b)(5). Final distribution at specified age (sec. 110(b) of bill)*

The bill adds a new exception to the throwback rule. It excepts from the operation of the 5-year throwback rules final distributions of a trust to a beneficiary upon his reaching an age specified in the governing instrument, (if the trust was created by will, or if the trust was an inter vivos trust which (immediately before the grantor's death) was revocable by him acting alone.

For example, the testator's will establishes a trust for his son. The income of the trust is to be accumulated and the corpus and accumulated income are to be paid to the son when he reaches age 40. The testator dies on January 1, 1960, when the son is 30. The distribution in 1970 is not within the exception provided by section 665(b)(3) of existing law because the trust was not in existence on January 1, 1954. The distribution in 1970 is excepted from the throwback rules by section 665(b)(4) of existing law, however, because the final distribution is made more than 9 years after the last transfer to the trust. If the testator died when the son was 35, however, the distribution would not be excepted under existing law from the operation of the throwback rules. The bill would except the distribution to the son from the throwback rules.

(e) *Section 665 (b)(6) and (e). Peel off trusts, etc. (sec. 110(b) of bill)*

Paragraph (6) added to section 665(b) by the bill provides a new exception to the throwback rules where the terms of the governing instrument (or applicable local law) require a trust to make a distribution to another trust upon the occurrence of an event. This exception would apply, for example, where the grantor provides that upon the occurrence of an event, such as the birth of a child, existing trusts are to contribute a trust fund to or for another trust (either existing or newly created).

The bill also provides that a proportionate share of the undistributed net income of each of the distributing trusts (and taxes imposed on

such trusts) for the preceding taxable years will be allocated to the receiving trust. The undistributed net income of, and taxes imposed on, the distributing trust shall be correspondingly reduced. In addition, the bill insures that the receiving or peel off trust will include in gross income, and the distributing trust will deduct from distributable net income, only the receiving trust's share of the distributable net income of each existing (contributing) trust for its taxable period up to the time of distribution to the receiving trust.

33. Section 666. Conforming changes (sec. 111 of bill)

The bill makes a conforming amendment to section 666 to reflect the proposed changes in the tier system.

34. Section 668(a). Conforming changes (sec. 112(a) of bill)

The bill makes conforming amendments to section 668 to take into account changes which have been made in the tier system.

35. Section 669. Multiple trusts (sec. 113(a) of bill)

The general approach of present law with respect to the taxation of trusts is to treat the trust as a separate entity which is taxed in the same manner as an individual, except that the trust is allowed a special deduction for distributions to beneficiaries, and the beneficiaries must include such distributions in their income. The trust serves as a conduit through which income passes on its way to the beneficiaries, and the income distributed by the trust retains its same tax character in the hands of the beneficiary.

If a grantor creates a trust under which the trustee is given discretion to accumulate the income for the benefit of designated beneficiaries, then to the extent the income is accumulated, it is taxed at individual rates to the trust. An important factor in the trustee's decision to accumulate the income may be the fact that the beneficiaries are in a higher tax bracket then the trust.

The multiple-trust problem results from the creation of more than one accumulation trust by the same grantor for the same beneficiary, and has no reference to the ordinary "simple" trust in which all the income is currently distributable. The splitting of the income among several taxable entities results in a reduction of the overall tax burden, since the accumulated income is taxed to each separate trust at lower rates than would be the case if only one trust were created.

Suppose, for example, that A sets up a trust under which he directs the trustee to pay the income to his wife, W, or accumulate the same, and then he sets up five other trusts that have the same provisions. It may be that under present law such arrangements create five separate tax entities, so that if the income is left in each trust to be taxed to such trust, the total tax will be much lower than if one trust had been established on such terms.

Suppose, for example, B has some property, the basis of which is quite low, and he wants to dispose of it and reinvest the proceeds. If he sells it, of course a substantial part of the proceeds may be required to pay the capital gains tax. He wants this property eventually to go to his son anyway, so he sets up 10 different trusts and puts one-tenth of the property in each trust. Each trust gives the income to the son for life, with the remainder over on the son's death to the issue of his son. The trustee of the 10 trusts sells the property in each trust and contends that there are 10 different tax entities to which the capi-

tal gains must be allocated, and if that is true, of course, the total tax on the gain realized from the sale will be substantially lower than if the property had been sold by one trust or by the grantor himself.

In the first example ordinary income has been split among the various trusts; in the second example capital gain has been split among the various trusts.

The bill adds a new section to deal with the problem of multiple trusts. In general, it provides for taxing the distributions from such trusts to the beneficiaries as ordinary income at the time they are received, but only to the extent that income was accumulated by the trusts in the preceding 10 years. In other words, the tax imposed on the beneficiary for the taxable year in which the multiple trust distribution is received will be increased in an amount equal to the additional taxes which would have been imposed on the beneficiary had such amounts actually been distributed to him in each of the preceding 10 years, instead of being accumulated by the trust. Generally speaking, where a grantor creates a series of trusts to distribute the accumulated income to the same beneficiary, the first trust making distributions would not be subject to the new multiple trust rules, but distributions from the second and succeeding trusts would be treated as multiple trust distributions.

Under the bill the Secretary or his delegate is given broad authority to require the grantor, the trustee, or any beneficiary of a multiple trust to furnish information to the extent necessary to carry out the purposes of the section. In addition, a new section is added to the code to require a trust to make an information return with respect to each beneficiary who receives a distribution under this section, and to furnish such information to the beneficiary receiving the distribution.

36. Conforming and technical amendments (sec. 113(b) of bill)

The bill makes various conforming amendments in sections 665(c), 666, 667, and 668.

In addition, the bill amends present law to provide that the beneficiary will receive a credit against his tax in an amount equal to the taxes paid by the trust which are considered as distributed to him under the throwback rules. Under present law, the beneficiary receives a credit equal to the portion of the taxes imposed on the trust which would not have been payable by the trust for the preceding taxable year had the trust in fact made distributions to such beneficiaries at the time and in the amounts specified under the throwback rules. Thus, under existing law the amount of the credit might be greater than the amount of taxes deemed distributed. Under the amendment, the amount of the credit will always be equal to the amount of taxes deemed distributed.

37. Section 671. Rules taxing income of a trust to grantor of trust (sec. 114 of bill)

Present law (secs. 671–677) treats grantors as the owners of all or a part of the trust property where they retain substantial dominion and control over the property transferred to a trust, and taxes them on the income therefrom. Present law (sec. 678) also taxes persons other than the grantor as the owner of any portion of the trust property over which they have a power exercisable solely by themselves to vest corpus or income in themselves.

Section 671 of present law states the general rule that where the grantor or another person is regarded as the owner of any portion of a trust there shall be included in computing the taxable income and credits of the grantor, or such other person, those items of income deductions and credits against tax of the trust which are attributable to that portion of the trust, as if the person deemed to be the owner of such portion of the trust were an individual.

The bill amends section 671—

(1) to conform section 671 to the repeal of section 678 (relating to powers in persons other than grantors) by the bill (see discussion under section 664),

(2) to make it clear that, to the extent that items of income, deductions, etc., are to be taken into account by the grantor under the provisions of sections 671 through 677, such items are not to be subject to the other rules relating to the taxation of trusts, estates, and beneficiaries (subparts A through D of part I of subchapter J), and

(3) to specifically recognize that persons other than individuals may be grantors of trusts subject to these rules.

88. *Section 674. Power to control beneficial enjoyment (sec. 115 of bill)*

Section 674(a) of present law contains the general rule that the grantor of a trust is to be treated as the owner of any portion of the trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition which is exercisable by the grantor or a nonadverse party (or both) without the approval or consent of any adverse party.

Sections 674 (b), (c), and (d) of present law contain exceptions to the general rule of section 674(a). The amendments to section 674 made by the bill are described below.

(a) *Section 674(b)(3). Power exercisable by will or deed (sec. 115(a) of bill)*

Under present law a power in any person exercisable only by will, to control beneficial enjoyment of the income is, generally speaking, excepted from the operation of the general rule of section 674(a).

The bill extends this exception to a power to appoint by deed, as well as a power to appoint by will, where the exercise of the power to appoint by deed cannot confer beneficial enjoyment of the trust property on anyone until after the death of the holder of the power. However, the exception does not apply to a power exercisable by deed which does not exclude the grantor and his estate as possible appointees.

(b) *Section 674(b)(5). Power to distribute corpus—Exception to exception (sec. 115(b) of bill)*

Present law excepts from the general rule of section 674(a) a power to distribute corpus to a class of beneficiaries under certain prescribed conditions.

However present law also provides that such a power will not be excepted from the general rule, if any person has a "power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, unless such action is to provide for afterborn or afteradopted children." This latter provision is known as the "exception to the exception," and where applicable, renders

inoperative the exception to the general rule provided in section 674(b)(5). This identical clause also appears in sections 674(b)(6), 674(b)(7), 674(c), and 674(d), and where applicable destroys the exceptions provided in those paragraphs and subsections.

The bill amends this provision of present law relating to the exception to the exception. The bill makes it clear that the prohibition against a power to add new beneficiaries does not apply to a power held by an adverse party nor to a power which qualifies as an exception under section 674(b)(3) discussed above. By substituting the word "change" for the word "add", the bill also makes it clear that the prohibition against a power to add beneficiaries includes a power to change beneficiaries. Under present law, provision for afterborn or after-adopted children is excepted from the prohibition against a power to add beneficiaries. As amended by the bill, provision for an after-acquired spouse is also excepted from the prohibition.

The amendments described above have also been made with respect to the exception to the exception clause found in sections 674(b)(6), 674(b)(7), 674(c), and 674(d).

(c) Section 674(b)(6). Power to withhold income temporarily (sec. 115(c) of bill)

Section 674(b)(6) provides another exception to the general rule of section 674(a) with respect to a power in the trustee to withhold income from a current income beneficiary if ultimately the accumulated income must go to such beneficiary, his estate, or his appointee or alternate takers in default of appointment, provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate.

If the grantor were excluded from this group of possible appointees the exception would not be operative and the grantor, who could not take, would be taxable. On the other hand, if the trustee were permitted to accumulate income for A, and A, by deed or will, can appoint back to the grantor, a tax avoidance possibly may exist.

The bill amends this provision to clarify the language and to close the possible loophole in present law by requiring that the grantor and his estate must be excluded from the class of possible appointees.

(d) Section 674(c). Exception for certain powers of independent trustees (sec. 115(e) of bill)

Present law excepts from the general rule stated of section 674(a) a power to (1) distribute, apportion, or accumulate income to or for a beneficiary or class of beneficiaries, or (2) to pay out corpus to a beneficiary or a class of beneficiaries provided the power is exercisable solely by a trustee or trustees other than the grantor, no more than half of whom are related or parties subservient to the grantor.

Under present law if the described powers are vested in three trustees, only one of whom is independent, the exception would be inoperative and the grantor would be treated as the owner of the trust income even though unanimous consent is essential to the exercise of the power.

The bill amends present law to extend the exception to a situation where the described powers are vested in cotrustees and one is independent if the concurrence of the independent trustee is necessary to the exercise of the power. For example, where the described

powers are vested in three trustees, one of whom is an independent trustee, if the unanimous consent of all trustees is essential to the exercise of the power, it will qualify under section 674(c).

(e) Section 674(d). Power to allocate income if limited by a standard (sec. 115(f) of bill)

The bill makes a conforming amendment in the first sentence by changing the words "none of whom is the grantor" to read "other than the grantor" to conform with the change made by the bill in section 674(c), above.

39. Section 675. Administrative powers (sec. 116 of bill)

Section 116 of the bill makes a clarifying amendment to section 675(2). Under existing section 675(2), the grantor is treated as the owner of any portion of a trust in respect of which he is enabled to borrow corpus or income without adequate interest or security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security. The bill strikes out "(other than the grantor)" and inserts "(other than the grantor acting alone)". Thus, the grantor would not be treated as owner where he is one of two or more trustees holding such a general lending power jointly.

40. Section 677. Income for benefit of grantor (sec. 117(a) of bill)

The bill amends section 677(b) to conform to the changes made by the bill in section 661(a).

41. Section 677(c). Existence of discretion as to income (sec. 117(b) of bill)

Under present law the grantor is treated as the owner of any portion of a trust whose *income* "in the discretion of the grantor or nonadverse party" may be distributed or accumulated for the benefit of the grantor or used to pay premiums upon policies of insurance on his life. Present law is not clear as to the extent to which it applies to a trust in which the trustee has discretion to distribute or accumulate income, but the grantor reserves a power to withdraw a limited amount of *corpus* in each year.

The bill adds a new subsection (c) to section 677 which provides that discretion (referred to in sec. 677(a)) exists to distribute *income* to the grantor or to apply *income* for the support of a beneficiary whom he is legally obligated to support or to apply *income* to the payment of premiums on policies of life insurance, even though the terms of the trust specify that the discretion relates only to *corpus*, to the extent that the income of the trust is not required to be distributed currently. Thus, where a grantor reserves a power to withdraw corpus, but gives the trustee discretion to distribute or accumulate the income for the benefit of another, the amendment makes it clear that the grantor will be taxed on the full amount of the trust income to the extent it was not required to be distributed currently.

42. Section 681. Limitation on charitable deductions (sec. 118 of bill)

The bill makes conforming amendments to section 681 made necessary by other changes made by the bill. (See comment under section 642(c).) It also amends present law to make it clear that a trust may obtain the benefit of section 170(b)(1)(A) of present law which allows the extra 10 percent deduction for contributions to a specified class of charities.

43. Conforming amendments (sec. 119 of bill)

Section 119 of the bill makes a number of technical changes to the code to conform its provisions to changes made by the bill in subchapter J.

44. Clerical amendments (sec. 120 of bill)

The bill makes clerical changes in tables of sections and headings.

45. Effective date (sec. 121 of bill)

The bill provides that except as otherwise provided in title I of the bill, the amendments made by title I of the bill shall apply with respect to taxable years ending after the date of the enactment of the bill.

Summary of Estate and Trust Provisions of H.R. 9662, Trust and Partnership Income Tax Revision Act of 1960

GENERAL STATEMENT

This bill is concerned with the revisions of two subchapters of chapter I of the Internal Revenue Code. These are subchapter J, which deals with the income tax treatment of estates, trusts, and beneficiaries, and subchapter K, which deals with the income tax treatment of partners and partnerships. The estate and trust tax provisions appear in title I of the bill and those relating to partners and partnerships in title II.

The work on these subchapters began with advisory groups established on November 28, 1956, by a subcommittee of the Ways and Means Committee. The reports of the advisory groups were completed by the end of 1958 and hearings were held on bills arising from these reports in February and March of 1959. The bulk of the advisory groups' recommendations both in the case of subchapter J and subchapter K have been incorporated in this bill, although there are important differences.

The House bill retains the basic structure of the present partnership provisions and, therefore, the changes made in these provisions by the bill are largely in the nature of modifications and perfections of the existing provisions.

Two of the changes made in the partnership provisions are designed specifically to reduce their complexity in operations, especially for the smaller, simpler partnerships. The first of these is a rearrangement of the partnership provisions. Under the rearrangement the provisions of general application which the smaller, simpler partnership is likely to have to use are placed first in the law, making it unnecessary in most cases for the members of these partnerships to familiarize themselves with the more technical provisions which follow. In addition the bill provides a simplified reporting procedure which can, at the election of the partnership, be followed in those cases where most of the partnership income (other than capital gains and losses and dividends) is ordinary income.

Probably the most important of the unintended hardships of existing partnership law dealt with by the House bill is the amendment relating to the time of the closing of the partnership taxable year for a partner who dies. Under present law this year continues to the normal ending of the partnership year with the result that the deceased partner's successor may lose an opportunity to offset against this partnership income, expenses incurred by the partner in his last year, as well as lose the benefits of income splitting. The bill provides that the partnership year is to close for a deceased partner at the time of his death although permitting his successor to elect to continue the year if they so desire.

Among other more important changes made in the partnership provisions, are those—

(1) Substituting for the present definitions of "unrealized receivables" and "inventory items" which may result in ordinary

income, a definition which determines whether an asset is an ordinary income asset by ascribing to it the same character it would have had if the asset had been held directly by an individual,

(2) Removing from existing law an unintended benefit wherein ordinary income treatment possibly may be avoided in the case of collapsible partnerships by borrowing funds and investing them in the partnership in a manner which reduces the ordinary income assets below a specified percentage of the total,

(3) Providing in the code for the imposition of tax in certain cases where services are exchanged for an interest in the capital of a partnership,

(4) Refining the rules which apply in the case of amounts paid by a partnership to a retiring partner or to a deceased partner's successor in interest,

(5) Clarifying the rules applicable to income in respect of a decedent, and

(6) Permitting an election at the organization level, rather than at the level of the individual members, as to whether to make the partnership provision inapplicable in the case of groups set up exclusively for investment, production, or extraction, but not for the sale, of property.

The changes made in the partnership provisions are described in more detail below.

II. GENERAL EXPLANATION OF PARTNERSHIP PROVISIONS

1. Rearrangement of partnership provisions

Present law first presents all of the provisions relating to the determination of tax liability, then contributions to a partnership, distributions by it, and transfers of interest in a partnership. This is followed by the provisions which may relate to more than one of these types of transactions referred to above.

The bill rearranges the partnership provisions to place in the first part those that are likely to be used by the average simple partnership and then by listing in parts II and III the more technical provisions. Within the parts, however, the same order of provisions is maintained as under present law, that is, the first subpart deals with the determination of tax liability, the second with contributions to a partnership, etc. This change would, of course, make it necessary to renumber many of the partnership provisions of existing law.

2. Section 702(b). Level for determining character of income

Present law provides that certain specified items of income, loss, deduction, or credit are to retain the same character in the hands of the partners that they had in the hands of the partnership. This includes items like capital gains and losses, charitable contributions, dividend income, etc. In addition, present law provides that the character of other items of the income, loss, deduction or credit, are to retain their character to the extent provided by the regulations. The bill provides that the character of *all* partnership items is to carry over into the hands of the separate partners. This actually does no more than provide in the statute the rule which is already laid down in the regulations.

The more important problem dealt with by the bill in section 702(b) is the manner of determining the character of items of income, gain, loss, deduction or credit. The bill provides that the character of items of income, etc., is to be determined on a partner-by-partner basis, depending upon the activities of each partner. However, due regard is to be given to any business, financial operation, or venture in which the partnership is engaged since the partnership is considered as carrying on this activity for the partner. This can be illustrated by a partnership which constructs a house and subsequently sells it. In this case the income realized in the case of partners who are real estate dealers probably would result in ordinary income. However, in the case of another partner who is not in the real estate business in his own right this would result in a capital gain unless it was determined that the partnership itself was in the business of buying and selling real estate.

3. Section 702(c). Gross income of a partner

This section deals with a possible double inclusion of the same amount in computing the gross income of a partner. One section in present law provides that the gross income of a partner is to include

his distributive share of the gross income of the partnership. Another section treats certain portions of the gross income of the partnership, namely, "guaranteed payments" as if they were wage or salary payments. These guaranteed payments may be included once as a part of the gross income of the partnership and a second time as a wage or salary payment. The bill overcomes this possible double inclusion by providing that the partner is to include in his gross income only the portion of the gross income of the partnership not already so taken into account as guaranteed payments.

4. Section 702(d). Limitations in computing taxable income (new subsection)

There are a number of limitations in present law which must be taken into account in computing taxable income. These include the $50 exclusion in the case of dividends received, the $1,000 limitation on the deduction of capital losses, the $100,000 limitation on exploration expenditures, the 25-percent limitation on soil and water conservation expenditures, the 20- or 30-percent limitation on charitable contributions, etc. Under present law the statute does not specify in the case of partnership income whether these limitations apply at the partnership or partner level. The regulations, however, provide that the limitations are to be applied at the partner level. The bill provides a statutory basis for this rule in the regulations. To do otherwise would permit the avoidance of the limitations by setting up multiple partnerships.

5. Section 702(e). Election for simplified reporting (new subsection)

For the small partnership, the carry-through from the partnership to the partner of the character of each item of income may give an exactness to tax computations which is of little benefit but adds considerably to the complexity of the computations on the partner's own individual income tax return. The bill provides that a partnership in such a case can elect a simplified type of reporting which nets at the partnership level most items of income and deduction into a single net ordinary income or loss item. The partners then share this single ordinary income item. Exceptions are provided in the case of capital gains and losses and dividend income. The character of these items under the House bill still carries through.

6. Section 703(b). Organizational expenditures (new subsection)

Expenses incurred in the organization of a partnership, such as fees for working out the partnership agreement, are capital expenditures and may not be deducted by the partnership. On the other hand, present law provides in the case of a corporation that it may deduct its organizational expenditures over a 5-year period.

The bill adds a new provision to the partnership law providing for the deduction of the organizational expenditures of a partnership ratably over a 5-year period. The expenses which may be so treated are those which are incident to the creation of a partnership or to the preparation of the first written partnership agreement. These expenses do not include any revision of, or substitute for, an already existing partnership agreement and they do not include expenditures to obtain capital contributions for the partnership. Such expenditures in the case of corporations are not treated as organizational expenditures which can be written off over the 5-year period. Thus

in effect the bill grants partnerships substantially the same treatment for organizational expenditures as is presently available in the case of corporations.

7. Section 705 and section 763. Determination of basis of partner's interest (present sec. 705(b) and (a))

Present law provides two alternative rules for determining the basis of a partner's interest in a partnership, for purposes of determining gain or loss upon subsequent sale or in the case of distributions. The rule now generally applicable is the more precise rule requiring adjustments for the partner's share of the partnership income and for each distribution made to him. The alternative rule provides that the basis of the partner's interest may be determined by taking his proportionate share of the basis of partnership property. Using the partnership basis usually is simpler since the partnership in any case must maintain this basis.

The bill provides that what is now the alternative rule is to become the general or standard rule and vice versa. The new general rule, however, will not apply if a revenue agent upon examination of a partner's return finds that there is a substantial difference between computing the basis of the interest under the simpler procedure and computing it under the more detailed and more exact alternative, unless the partner makes adjustments to take the more important of these differences into account.

8. Section 706. Changing or adopting a taxable year

Where the principal partners are on different taxable years, the statute appears to require establishment of a business purpose for *any* taxable year selected for the partnership. The regulations, however, provide that a newly formed partnership may adopt the calendar year as its taxable year without securing prior approval if all of the principal partners are not on the same taxable year. The bill amends the statute to clearly provide for the rule now contained in the regulations.

The present partnership provisions seem to indicate that a principal partner may change his taxable year to that of a partnership in which he is a principal partner without obtaining the consent of the Treasury Department. However, the regulations, based upon another provision of the law (sec. 442), provide that a partner, even though changing his taxable year to that of the partnership, can do so only upon approval of the Treasury Department. The bill amends the partnership provisions to make the rule now in the regulations clearly applicable.

9. Section 707. Transactions between partners and partnerships (present sec. 707 (a) and (c))

These are conforming changes.

10. Section 708(b)(1)(B). Termination of a partnership on sale to another partner of an interest of 50 percent or more

Present law provides that a partnership is to terminate if within a 12-month period there is a sale of 50 percent or more of the total interests in partnership capital and profits. However, no termination occurs where a distribution is made to one or more partners of 50 percent or more of the partnership assets.

The bill in effect extends the distribution rule in this case to sales of partnership interests. It provides that a partnership is not to terminate upon the sale of an interest (regardless of the percentage sold) to partners who have been members of the partnership for at least 12 months prior to the sale.

11. Sections 721 and 722. Contributions to a partnership

These changes are closely related to the changes made in section 770 and are included in the discussion on that section in No. 24 below.

12. Sections 731 and 732. Extent of recognition of gain or loss on distribution and basis of distributed property other than money

These are conforming changes.

13. Section 734. Basis of undistributed partnership property (present sec. 734(a))

These are conforming changes.

14. Section 735. Character of gain or loss in the case of sales or exchanges of distributed property (present sec. 735(a))

Presently if a partnership distributes unrealized receivables and inventory items to a partner which he in turn sells, any gain realized by him is ordinary income in the case of inventory items, if they are sold within 5 years of the distribution, and in the case of unrealized receivables irrespective of how long after the distribution the sale occurs.

Both in the case of unrealized receivables and inventory items present law refers to a gain or loss by "a distributee partner." Thus apparently the ordinary income treatment for this property would not apply in the case of the sale by a donee of the partner. The bill amends present law to provide ordinary income treatment in the case of the sale of unrealized receivables or inventory items not only in the case of the distributee partner but also in the case of donees and others who have the same basis for the property as the distributee partner.

The bill also removes the 5-year limitation presently applicable to inventory items. As a result, inventory items, like unrealized receivables at present, when sold by a distributee partner (or donee) will always result in ordinary income to him (or the donee).

15. Section 736. Holding period for partnership property (present sec. 735(b))

This section involves only conforming changes.

16. Sections 741 and 743. Transfers of interest in a partnership (present secs. 741 and 743(a))

These sections involve only conforming changes.

17. Sections 749, 750, and 751. Collapsible partnership transactions (present sec. 751)

The collapsible partnership provision is intended primarily as a means of preventing the conversion of what would eventually be ordinary income into capital gains by a partner selling his interest in a partnership instead of the partnership directly selling the property involved. For example, if it were not for this provision, and practically all of the assets of a partnership consisted of inventory, it would be possible to avoid the ordinary income treatment, which eventually

would apply if the inventory is sold, by selling the interest in the partnership instead (which would generally result in capital gain). Similarly, in the case of distributions, the collapsible partnership provision blocks the shifting of ordinary income and capital gain items among partners, as they might want to do where they are in different income brackets, by providing ordinary income treatment where on a distribution a partner gives up (or in effect sells) part of his share of ordinary income items to the other partners through a disproportionate distribution (disproportionate in that he receives more or less than his share of the ordinary income assets). The types of property treated as ordinary income assets are "unrealized receivables" and "inventory items which have substantially appreciated in value." In determining whether the inventory items have substantially appreciated in value, two tests are applied, one, to see whether there has been a significant increase in the value of the assets (their fair market value must exceed 120 percent of their basis) and the other to determine whether their value is an appreciable part of the value of all of the assets involved in the transaction (more than 10 percent of the value of all of the partnership property other than money).

(*a*) *Gain on ordinary income assets whether or not an overall gain.*—It is not clear under present law whether the ordinary income treatment applies only where there is an overall gain on the sale of an interest or whether it also applies where there is a gain on the ordinary income assets even though there is no overall gain on the sale of the interest. The bill makes it clear that the ordinary income treatment applies where there is gain on the ordinary income assets even though a loss on the overall transaction.

(*b*) *Exception for drawings and advances.*—At present the regulations provide that the collapsible partnership provisions do not apply in the case of drawings and advances with respect to the partner's share of the partnership income for the calendar year. The bill makes this exception specific by adding it to the statute.

(*c*) *Definitions of unrealized receivables and inventory items.*—The bill provides a new definition for the ordinary income assets subject to the collapsible partnership provision. In general, it defines these ordinary income assets, or section 751 assets as they are called, as assets which if held by an individual would result in ordinary income upon their sale. This is a substitute for the present detailed definitions of unrealized receivables and inventory items. This rule is provided both to simplify the law and also to provide the same treatment in this respect for partnerships as for individuals.

(*d*) *Application of substantial appreciation tests.*—Under present law the substantial appreciation test applies only to inventory items. Under the bill it is to apply to *all* section 751 assets. This is necessary if there is to be only a single category of section 751 assets.

(*e*) *Use of liabilities in substantial appreciation test.*—In determining whether there is substantial appreciation, the bill removes an unintended benefit in present law whereby real estate developers and others through the use of liabilities (such as mortgaged property) have avoided the ordinary income treatment. This has been done by reducing the value of the section 751 assets below 10 percent of the value of all assets by borrowing funds and purchasing additional non-section 751 assets. The bill avoids this result in applying the 10-percent test by

reducing the fair market value of the partnership property for purposes of the application of this test by any liabilities of the partnership.

(*f*) *Offsets of section 1231(b) losses.*—Taxpayers generally can reduce any ordinary income subject to tax by any net loss on section 1231(b) assets (generally real and depreciable property used in the trade or business). The bill in order to provide as nearly the same ordinary income treatment where a partnership interest is involved in a transaction specifies that the income treated as ordinary income is to be reduced by any loss referred to as a "section 751(b) loss," that is, a loss with respect to section 1231(b) property.

(*g*) *Determining character of collapsible partnership property.*—The bill provides that the determination of whether or not property is an ordinary income asset is to be made at the time of the sale of the interest or distribution of the property, and as if the property were sold directly by the person relinquishing the property. In this case, as in the case of the sale of property by the partnership (see sec. 702(b) or No. 2) due regard is to be given to any business, financial operation, or venture in which the partnership is engaged. As a result, whether or not an asset is an ordinary income asset may vary from partner to partner according to his own activities, although the partnership activities also will be attributed to each of the partners.

18. Section 761. Special rules for contributed property (present sec. 704(c) (2) and (3))

These are conforming changes.

19. Section 762. Family partnership provisions (present sec. 704(e))

These are conforming changes.

20. Section 763. Alternative rule for determination of basis of partner's interest (present sec. 705(a))

This provision was discussed in connection with section 705.

21. Section 764. Closing of a taxable year for a deceased partner or partner who sells or exchanges part or all of interest (in part new and in part present sec. 706(c)(2))

Present law provides that the taxable year of a partnership with respect to a partner who *dies* is not to close prior to the end of the regular partnership taxable year. This was designed to prevent the "bunching" of more than 1 year's income for tax purposes in the last year of a partner who dies. This could happen, for example, if it were not for this rule in present law, where a partner is on a calendar year but the partnership is on a fiscal year. This can be illustrated by a partnership year which ends on January 31, 1958, where the partner involved is on a calendar year and dies in December 1959. The partnership income for 1958 in this case is included in the income of the partner for his last year but in addition if the 1959 partnership year ends upon his death then he must also include in the same year the income of the 1959 partnership year. Therefore, as much as 23 months' income of a partnership may be included in 1 year of a partner. Although the rule in present law overcomes the problem with respect to bunching of income, it overlooks what is probably the more common case, namely, the case where the partner and the partnership are both on a calendar year. In such a case, it usually is more important in the case of the income of the deceased partner to have the opportunity

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to offset the partnership income against deductions, exemptions, and other benefits available in the year of death than it is to avoid any possible bunching of partnership income.

As a result, the bill provides that as a general rule the partnership taxable year in the case of a deceased partner is to close as of the date of his death. However, the bill further provides that the successor in interest is to have the option to continue the year through the normal ending of the partnership year where there has been no sale, exchange, or liquidation of this interest before that date. Where the interest, or any part of it, has been sold, exchanged or liquidated, after the death of the deceased partner but before the end of the partnership year, the successor is to have the option to continue the partnership taxable year for the decedent's interest to the date of this disposition. Where there is an agreement to sell, exchange or liquidate part or all of the interest which is effective on the date of death, the successor in interest is to have the option to continue the partnership taxable year for the decedent's interest until the day following the date of the decedent's death.

22. Section 765. Certain sales or exchanges of property with respect to controlled partnerships (present sec. 707(b))

Under present law as a general rule if a partner engaged in a transaction with a partnership other than in his capacity as a member, the transaction is considered as occurring between the partnership and one who is not a partner. Certain exceptions, however, are made to this rule. One of these exceptions provides that losses are to be disallowed in the case of sales or exchanges of property between a partnership and a partner owning more than 50 percent of the interest in the partnership and also in the case of two partnerships where the same persons own more than 50 percent. In the case of a gain, any gain recognized on the sale or exchange of property other than a capital asset is treated as ordinary income where the partner has an interest in the partnership of 80 percent or more or the same persons own directly or indirectly more than 80 percent of the interest in two partnerships between which the transaction occurs. Essentially these are the same limitations on the recognition of loss and the same provision for the treatment of gains as ordinary income as is presently applicable in the case of corporations. The bill makes certain modifications in these exceptions which are described below.

(*a*) *Transactions between a partnership and a "person."*—The bill changes the reference to transactions between a "partner" and a partnership to transactions between a "person" and a partnership to make it clear that a loss may be disallowed or a gain taxed as ordinary income even though the person making the sale is a person closely related to the partner rather than the partner himself.

(*b*) *Direct or indirect ownership.*—In both the gain and loss provisions the words "directly or indirectly" are deleted from the reference to ownership between a person and a partnership as being unnecessary in view of the specific constructive ownership rules applicable in these cases. This phrase is also removed in the case of the ownership between two partnerships for the same reasons.

(*c*) *Losses between a partnership and a corporation or a trust or estate.*—The bill expands the loss provisions to cover losses which may arise in the case of sales or exchanges between a partnership and

a corporation or trust or estate where there is ownership of common interest of more than 50 percent. It also makes this the exclusive rule for transactions of this type.

(*d*) *Transfers involving land.*—The bill makes the ordinary income treatment for gains inapplicable where the transfer involves land used in a trade or business. The exclusion under present law applies only to capital assets. This exclusion for capital gains presently is provided because they, if sold directly would only result in a capital gain or loss. This, however, is also true of land used in a trade or business, and since such property does not result in depreciation deductible against ordinary income, there appears to be no tax advantage gained by trading such property in the controlled situations.

(*e*) *Definition of "common interests."*—Both in applying the 50 percent test in the case of losses and the 80 percent test in the case of gains, the bill uses the term "common interests." Under the bill this term "common interests" is determined with respect to two or more persons by adding together the smaller interests which each has in both of the organizations in question. Thus where partners A and B share the ownership of one partnership on a 10 percent-90 percent basis and of another partnership on a 90 percent-10 percent basis, the common ownership of A in the two partnerships would be 10 percent. The common ownership of B also would be 10 percent, with the result that the total common ownership owned by the two partners would be 20 percent. Under present law, merely because both A and B are members of both partnerships and together own more than a 50-percent interest in each partnership, a loss resulting from the sale of property between these two partnerships would be ignored even though in reality the sale between the two partnerships represent a shift in equity ownership between A and B to the extent of 80 percent.

23. Section 766. Continuing partnerships in mergers or consolidations and divisions (present sec. 708(b)(2))

These are conforming changes.

24. Section 770. Interest in partnership capital exchanged for services (new section)

Present law provides that no gain or loss is to be recognized to a partnership or to any of the partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. The regulations state that this provision does not apply to the extent a partner gives up a part of his capital interest as compensation for services rendered by the person. Instead the regulations provide that the value of the interest transferred is income to the person performing the services to the extent of the fair market value of the interest transferred.

The bill in general follows the result obtained in the regulations although it does not wait and value the services at the time they are completed in the case of services to be rendered in the future.

The bill recognizes ordinary income to the partner performing the services and treats the amount taxed to him as a contribution by him to the partnership. In the case of the existing partners, a deduction is allowed at the partnership level where the services performed by the service partner are a trade or business expense, and then this deduction is allocated among the existing partners. If the services performed are of a nature which gives rise to capital

values in the partnership (such as services which an architect might render in designing a building) the basis of the partnership properties is increased by an amount representing the services.

Generally, the amount to be taxed to the service partner is the same as the deduction available through the partnership to the existing partners or to the addition in basis of partnership properties where capital values are involved. If the interest in the partnership is transferred to the service partner without substantial restrictions as to transferability, the bill provides that the amount taxable to him (and deductible to the other partners or increasing the basis of partnership properties) is to be the fair market value of the interest at the time of the exchange. However, where the interest is subject to substantial restrictions as to transferability, the bill provides that the amount to be taken into account when these restrictions cease to be substantial is to be the fair market value of the services performed or the fair market value the interest would have had at the time of the exchange had there been no such restriction.

Although the amount described above generally is the amount taxable to the service partner and deductible to the other partners (or the amount by which the capital value of partnership properties is increased) the amount available as a deduction to the existing partners cannot exceed the basis of the interests which they transfer to the service partner.

The application of the provision in the House bill can be illustrated by a partner who performs services for a partnership and in exchange receives (without any restrictions as to transferability) a 10-percent interest in the partnership. If the fair market value of this 10-percent interest is $500, the service partner will be taxed on this amount as ordinary income without regard to the basis that the other partners had in this 10-percent interest which they gave up. If the services performed were in the nature of a capital item (for example, the services performed by an architect who designs a building to house the partnership) this $500 would be treated as increasing the basis of partnership properties by that amount. On the other hand, if this $500 service was a deductible expense to the partnership (for example, serving as assistant manager in a grocery store) it would be divided up among the other partners and be available to them currently as a deduction. However, the deduction would be available to them only to the extent of the basis they had in the interest given up. For example, if there were two of these partners, A and B, and A had a basis of $200 for the 5-percent interest he gave up and B had a basis of $300 for the interest he gave up, A could take only $200 of the $250 otherwise due him as a deduction, although B would be entitled to the full deduction of $250.

In the above example, it was assumed that there were no restrictions as to the transferability of the interest received by the service partner. If there had been restrictions providing, for example, that the service partner could not transfer the interest for a period of 5 years, then there would be an attempt to value the services directly and their value, if less than the value of the interest without any restrictions, would determine the amount of taxable income to the service partner. The income would not be taxable to him, however, until these restrictions were removed nor deductible (nor capitalized) by the partnership for the other members until that time.

25. Section 770. Amounts paid to a retired partner or a deceased partner's successor in interest (present sec. 736)

Present law provides that where amounts are paid to a retiring partner or successor in interest of a deceased partner in liquidation of a partnership interest, the amount is subject to the regular distribution rules to the extent it is in exchange for the partner's share of the partnership property and therefore any amounts paid in this respect generally result only in capital gains. However, amounts paid in excess of the distributive share are treated as ordinary income to the retiring partner or successor in interest. Payments for unrealized receivables are an exception to this rule, since they in all cases are treated as ordinary income rather than as a payment for the capital interest. Payments for an interest in good will also may be an exception, since they are not considered to be payments for a capital interest unless the partnership agreement so provides. The bill retains this basic classification found in present law. However, it has added a number of rules making the application of this provision more specific.

(*a*) *Time of taking ordinary income payments into account.*—Under the bill ordinary income payments generally are taken into account as of the last day of the partnership year in which they are paid or become payable. However, they may be taken into account under the bill in the year with respect to which they are determined if they are paid by April 15 of the following year in the case of calendar year partnerships (or within a corresponding period for other partnerships). Present law does specify when these amounts are to be taken into account.

(*b*) *Extent to which special income characteristics follow.*—The bill provides that amounts which are taken into account in the year with respect to which they are paid rather than in the year for which they are determined are to be classified as "guaranteed payments." This means that in these cases the special characteristics of partnership income (such as capital gain, as distinguished from ordinary income) will not be carried through to the retired partner or heir. These characteristics under the bill are carried through, however, where the payments are attributed to the year in which the payments are determined. In such cases they are known as "distributive shares."

(*c*) *Special definition of unrealized receivables.*—As indicated previously, for purposes of most of the partnership provisions, unrealized receivables, inventory items, and other ordinary income items have been combined into a single category known as section 751 assets. However, in the case of retiring or deceased partners, only payments with respect to unrealized receivables have been placed in all cases in the ordinary income category. Therefore, it is necessary under the House bill to provide a special definition of unrealized receivables for purposes of this section. The definition added is similar to that in existing law except that the bill limits the application of the definition in the case of services *to be* rendered or *to be* produced. Services not yet performed are omitted from the definition. In the case of goods, those not yet delivered where a partnership is predominantly in a distributing trade or business also are omitted. For manufacturing and similar types of business the term includes goods produced but not yet delivered where orders have been placed at the time of the withdrawal from the partnership of the deceased or retiring partner.

(d) *Distribution rules to apply to distributions made in a 12-month period.*—The bill provides that where all of the payments with respect to a partnership interest are made within a 12-month period, the entire amount is to be treated as coming under the regular distribution rules with no part being especially classified as an ordinary income payment except to the extent so classified under the collapsible partnership rules.

(e) *Distributions of money and other property.*—Where a distribution includes both money and other property, the bill provides that the money is first to be considered as the ordinary income amount with the other property generally being classified as the payment with respect to the interest in the partnership being liquidated. This is provided in order to simplify the distribution rules in such cases.

(f) *Section 776(a) payments where the partnership goes out of existence.*—The bill provides that the ordinary income treatment provided for payments by section 776(a) is to continue for the recipient of these payments so long as they are continued regardless of the form of the business organization which makes the payment. Also the bill provides that even though the person making the payment is no longer operating in a partnership, a deduction is to be available to him if he is an individual who was a partner before the retirement or death, is under a legally binding obligation to make the payment and is carrying on a trade or business as a sole proprietor.

26. *Sections 691, 777, and 1014(c). Income in respect of decedent and property acquired from a decedent* (*present sec. 753*)

Present law provides that amounts includible in the gross income of an heir of a deceased partner as ordinary income under what in this bill is section 776(a) are to be considered as income in respect of a decedent under section 691. As a result, the discounted value of these amounts are includible in the gross estate of the decedent partner for estate tax purposes; then subsequently, when these amounts are paid the recipient is subject to ordinary income tax and obtains no basis with respect to the amounts as a result of the transfer at the decedent's death. However, the effect of imposing both an estate tax and an income tax with respect to the same amount, in the case of all amounts considered as income in respect of a decedent, is mitigated by granting a deduction to the recipient of these payments for the portion of the estate tax paid which is attributable to them.

The bill adds three new categories to "income in respect of a decedent." First, it provides that income in respect of a decedent treatment is to apply to the distributive share of income attributable to the part of the year occurring prior to a deceased partner's death (this is in conformity with the present regulations). Second, it provides that amounts attributable to unrealized receivables not already treated as income in respect of a decedent as a result of the operation of section 776(a) are to be so classified. Third, it provides that the amount required to be taken into account in income by a service partner as a result of the exchange of an interest in capital of a partnership for his services is to be treated as income in respect of a decedent if the interest is acquired by a successor in interest by reason of death and the restrictions are continued beyond the date of death.

An amendment is also made to section 1014(b) of existing law to provide that there is to be no change in basis of property as a result

of death for the portion of the value of an interest in a partnership attributable to property which represents a right to receive income in respect of a decedent under section 691.

27. *Section 780. Manner of electing optional adjustments to basis of partnership property (present sec. 754)*

Present law provides that a partner who has acquired his interest by purchase, inheritance, or other transfer (see sec. 782 in bill) may have a special partnership basis for property equal to the amount he paid for the interest (or its value if he acquired it by inheritance). Present law also provides that an election may be made to adjust the basis of partnership property where the property is distributed and takes a different basis in the hands of the distributee than it had in the hands of the partnership, or where property is distributed and gain is recognized to the distributee (see sec. 781 in the bill). At present if a partnership elects to make this adjustment with respect to transfers it must also make the adjustment with respect to distributions, and vice versa. Once such an election is made it generally applies to all subsequent distributions and transfers.

The House bill separates the election with respect to transfers and distributions. As a result it will be possible to make the election, for those who acquire an interest by transfer, to increase (or decrease) the basis of partnership property by the difference between the amount they paid for the partnership interest (or its value at that date in the case of inheritances) and its former basis, without requiring adjustments at the partnership level when distributions are made or vice versa.

The regulations under existing law provide that the election with respect to a special basis for partnership assets in the case of transfers, and in the case of distributions, must be made in a written statement filed with the partnership return to which the election applies. The House bill provides that the partnership is to have until 1 year after the date prescribed by law for filing the return for the filing or changing of these elections.

28. *Section 781. Optional adjustment to basis of undistributed partnership property (present sec. 734(b))*

Where the partnership has elected to make adjustments to property as a result of distributions, present law provides that the basis of partnership property is to be increased by any gain recognized to the distributee partner, and also where the distributed property has a basis to the partnership in excess of the basis attributed to the property in the hands of the distributee. It also provides for decreases in the reverse situations.

The bill makes two changes in this provision. First it changes the method of making the adjustments to the remaining partnership property. It provides that, instead of the adjustment referred to above, the partnership property is to be adjusted by the difference between the basis to the partnership of the distributed property and the reduction which occurs in the distributee partner's proportionate share of the basis of the partnership property.

The intent of this provision is to provide the partnership with the option to maintain the same basis in the aggregate as is represented by the total bases of all of the partnership interests. However, this relationship may already have been distorted before the partnership made this election. As a result the rule in present law sometimes

reaches the wrong results. This can be illustrated by the following example: Assume that the assets of the equal partnership ABD generally have a partnership basis of $9,000 and a fair market value of $15,000. Assume that D, who recently purchased his interest in the partnership from C for $5,000, has a $5,000 basis for his interest. A and B each has a basis for his partnership interest of $3,000. Under existing law if a $5,000 cash distribution is made by the partnership to either A or B in liquidation of his interest, the partnership would be entitled to an upward adjustment of $2,000 to the basis of remaining partnership assets. However, a similar distribution to D would result in no adjustment. Under the House bill there would be a $2,000 adjustment regardless of which partner received the distribution.

The second change made by the bill is to provide a de minimis rule where the adjustments which otherwise would be made with respect to a distribution are less than $1,000. The bill provides that, even though the partnership has elected to make adjustments generally, it may not do so where these adjustments in total (either in the case of an increase or a decrease) amount to less than $1,000.

29. Section 782. Optional adjustment in the case of transfer of an interest (present sec. 743(b))

The present law provides that a partnership can elect to adjust the basis of partnership property for purposes of a transferee partner so that he will have a basis for the partnership property equal to his purchase price (or value of the interest at time of acquisition if he acquired it by inheritance). If a partnership elects to make this adjustment it is binding for all future transfers and distributions as well unless permission for revocation is received from the Secretary or his delegate.

The House bill provides that, even though a partnership has elected to make the adjustment to partnership properties for transferees generally, it is not to make this adjustment where the total adjustment with respect to a transfer is less than $1,000 (either in the case of an increase or decrease). This change is comparable to the change made by the bill in the case of distribution adjustments referred to in No. 28 above.

30. Section 783. Allocation of basis for optional adjustments (present sec. 755)

Certain allocation rules are set forth in present law to use, where a partnership has elected to provide transferee partners with a special partnership basis, or where it has elected to make adjustments to remaining partnership property in the case of distributions, in specifying how the bases of the partnership properties are to be adjusted to reflect the changes required. The general rule provides that the additional (or decrease in) basis is to be allocated among the partnership properties in a manner which reduces the difference between their fair market value and their adjusted basis (or in any other manner permitted by regulations). However, certain limitations are provided with respect to these allocation rules. First, the allocation rules are to be applied separately between capital assets and trade or business properties on one hand and other property on the other hand. Second, the basis of any partnership property may not be reduced below zero. Third, in the case of a distribution where the adjustment to the basis of property is prevented by the absence of property of

the same class on the part of the partnership, or by an insufficient basis, the adjustments are to be held in abeyance and then applied subsequently to newly acquired property.

The House bill makes two changes in these allocation rules. First, in the case of transfers of interest it removes the requirement that adjustments to basis of partnership property must be made separately for capital assets and depreciable property on one hand and other property on the other hand. This rule is retained, however, in the case of distributions where it is needed to prevent the shifting of income from the ordinary income category to the capital gains category. This problem does not exist, however, in the case of transfers because no assets are removed from the partnership and as a result the assets which gave rise to the additional basis on the transfer still remain in the partnership and any additional basis can be allocated to them.

Second, the bill adds to the statute an allocation rule presently set forth in the regulations which provides that no basis may be allocated to assets where their basis already is equal to, or exceeds, their fair market value.

31. Section 784. Special basis to transferee upon subsequent distribution (present sec. 732(d))

These are conforming changes.

32. Section 785. Special basis to transferee upon subsequent sale or exchange (new section)

Where a partner acquires an interest in a partnership by purchase or inheritance but the partnership does not elect to give him a special transferee basis (for any increase in the value of his interest over its basis in the hands of the former partner), present law provides that if a *distribution* is made to such a partner within 2 years of the time he acquired the interest he may treat the interest at the time of the distribution as if it had the special partnership transferee basis. This rule provides a way out where the old partners and the new partner cannot agree as to a special transferee basis. This permits the new partner to withdraw from the partnership without losing any of the basis that he has for his interest. No such rule is available under present law, however, where, after an individual acquires an interest by purchase or inheritance, he *sells* this interest within 2 years of its acquisition.

The House bill adds a new section which in effect provides the same treatment where a partner sells an interest within 2 years of its acquisition, as is presently available in similar situations where a distribution is made within such a 2-year period. This rule is important in the case of the sale of an interest where there has been an increase in the basis of the interest attributable to inventory. In such a case the additional basis for the inventory upon a subsequent sale can be allocated to these assets and in this manner prevent the imposition of a second ordinary income tax with respect to the same inventory.

33. Section 788. Exclusion of certain organizations from partnership provision (present 761)

Present law provides that two special categories of organizations may be excluded from the application of all or a part of the partnership provisions if the members so elect, and if the income of the members can be adequately determined without the computation of part-

nership taxable income. These are organizations set up for investment purposes only, or for the purpose of jointly producing, extracting, or using property, but not for its sale.

Certain difficulties have been created by the requirement of present law that the organizations referred to can be excluded from the partnership provisions only if the election is made by *all* of the members. The House bill permits the organization itself to file the election as to whether or not it will be excluded from the application of all or a part of the partnership provisions. Thus, it would not be necessary to obtain the consent of all the members.

34. Section 204 of bill; effective dates

Generally the partnership provisions are made applicable to any partnership taxable year beginning on or after the date of enactment of this bill and with respect to any part of a partner's taxable year falling within such a partnership taxable year. Certain special effective dates, however, are provided:

(1) Section 735, which relates to the character of gain or loss on the disposition of distributed section 751 assets, is to apply only if the distribution by the partnership took place in a partnership taxable year beginning on or after the date of enactment of the bill (without regard to the date on which the distributee disposed of the assets).

(2) Section 764, relating to the closing of a partnership taxable for deceased partners or partners who sell or exchange all of their interests, is to apply only if the partners die or sell their interest on or after January 1, 1960.

(3) Section 765, relating to certain sales or exchanges of property with respect to controlled partnerships, is to apply only if the loss or gain to which the section relates arose from a sale or exchange occurring after the date of enactment of the bill.

(4) Section 770, relating to an interest in partnership capital exchanged for services, is to apply only with respect to exchanges occurring during a partnership taxable year beginning on or after the date of enactment of the bill.

(5) Section 776, relating to amounts paid to a retired partner or a deceased partner's successor in interest, is to apply only with respect to partners who die or retire during a partnership taxable year beginning on or after the date of enactment of the bill.

The amendments made to section 691 and 1014 of the code, dealing with income in respect of a decedent and basis in the case that the property received from a decedent, are to apply only with respect to decedents dying in a partnership taxable year beginning on or after enactment of the bill.

Senator FREAR. The first witness this morning is Hon. Jay W. Glasmann, Assistant to the Secretary of the Treasury.

Mr. Glasmann, we are mighty happy to have you here for testimony. We look forward with interest to that which you have to say, which I am sure will be of a very convincing nature.

STATEMENT OF JAY W. GLASMANN, ASSISTANT TO THE SECRETARY OF THE TREASURY; ACCOMPANIED BY MICHAEL WARIS, JR., ASSISTANT HEAD, LEGAL ADVISORY STAFF; AND ROBERT M. WILLAN, LEGAL ADVISORY STAFF

Mr. GLASMANN. Thank you very much, Mr. Chairman.

I have on my left Mr. Robert Willan, and on my right Mr. Michael Waris, of the legal advisory staff of the Treasury.

Senator FREAR. Thank you. And at my rear we have the referees on the joint committee, sir.

As usual, you may proceed in the manner you think best.

Mr. GLASMANN. The Treasury Department welcomes this opportunity to present its views on H.R. 9662, a bill which would make a number of important substantive and technical changes in subchapters J and K of chapter 1 of the Internal Revenue Code. These subchapters deal with the income tax treatment of estates, trusts and beneficiaries, and partners and partnerships.

As you know, in 1954 the Congress substantially revised and enlarged the statutory provisions of the income tax laws relating to estates and trusts (subchapter J), and for the first time spelled out detailed rules for the taxation of partners and partnerships (subchapter K).

With several years of practical experience under these subchapters, it has become evident that many of the rules in these complex areas of the tax law can and should be clarified and improved. H.R. 9662 is intended to bring about such needed clarification and improvement. With few exceptions, the Treasury Department supports the changes embodied in this legislation.

BACKGROUND OF H.R. 9662

H.R. 9662 had its beginning in the fall of 1956 when a subcommittee of the House Ways and Means Committee appointed a number of eminent attorneys and accountants to serve as advisers to the subcommittee in its study of the possible revision of subchapters J and K of the Internal Revenue Code.

The advisory groups on subchapters J and K held many meetings between November 1956 and December 1958, with the members devoting many hours to their extensive and difficult task. Printed preliminary reports, including drafts of statutory amendments, were submitted to the subcommittee of the Ways and Means Committee by the advisory groups and released to the public late in 1957. Members of the advisory groups then testified before the full Ways and Means Committee in January and February of 1958, discussing in considerable detail their reports and legislative recommendations. To facilitate consideration of the changes proposed by the advisory groups,

bills were introduced in the House to make the proposed changes readily available to the interested public.

Thereafter, the final reports of the advisory groups were completed in December 1958, and during February and March 1959 the Ways and Means Committee held extensive public hearings on these reports. Members of the advisory groups again appeared and gave detailed explanations of their recommendations. The committee also received comments on the advisory groups' proposals from the Treasury Department and from interested members of the public.

Before turning to a discussion of the provisions of the bill, I should like again to express publicly the appreciation of the Treasury Department for the distinguished service performed by those serving on the advisory groups on subchapters J and K. Their excellent work in assisting the Congress in its study of these technical and complex areas of the tax law has made possible the pending legislation.

The bill which is before the committee today would make important changes in both subchapters J and K. The bill is well over 100 pages long, and its subject matter for the most part is both technical and complex. If the committee wishes us to do so, we can proceed with a section by section discussion of the bill.

In view of the involved nature of the bill, however, we believe that we can be of greater help to the committee if we concentrate on those areas of the bill which are of major interest or which are controversial.

Senator FREAR. I think that would be preferable if the other committee members agree with that.

Might I also ask if you bring out in your testimony the parts that you do or which you do not hold in conformity with the bill.

Mr. GLASMANN. We do, Mr. Chairman.

Senator FREAR. Parts which you disagree with?

Mr. GLASMANN. We will discuss those areas in which we are in disagreement or where we suggest modifications.

TITLE I—TRUSTS AND ESTATES

By way of introduction to a discussion of the more important amendments in the trust and estate area (title I of the bill), it may be helpful to the committee if I describe in very general terms several of the basic rules governing the taxation of trust and estate income under subchapter J of present law.

(1) Income currently distributed or distributable by a trust or an estate is considered to pass through the trust or estate as a conduit, and is taxed to the beneficiaries as if the trust or estate had not intervened between the beneficiaries and the ultimate source of the income.

(2) Income which is not currently distributed or distributable, and which is accumulated by the trust or estate, is taxable to the trust or estate as if it were a separate individual taxpayer.

(3) Income distributed by the trust or estate retains its tax character in the hands of the beneficiary. For example, tax-exempt interest and long-term capital gain received by a trust and distributed to a beneficiary are treated for tax purposes in the hands of the beneficiary as tax-exempt interest and long-term capital gain.

(4) Because the income accumulated by a trust is taxable to the trust rather than the beneficiary, a reduction of tax will usually result whenever the trust is in a lower tax bracket than the beneficiary. In recognition of the abuses possible in this area, Congress in 1954 added the so-called 5-year throwback rule to the Internal Revenue Code.

In substance, this rule provides that if in any year a trust makes a distribution in excess of its "distributable net income" for the year, the excess will be included in income of the beneficiary to the extent of the accumulated income of the trust for the preceding 5 years. The concept of "distributable net income" came into the tax law in 1954 and is used to measure the amount includible by beneficiaries in their taxable income. Generally speaking, it is the taxable income of the trust with certain adjustments.

For example, no deduction is allowed for distributions to beneficiaries, or for the personal exemption allowed trusts and estates in computing the distributable net income of the trusts.

Under the throwback rule, the tax payable by the beneficiary on the receipt of accumulated income cannot exceed the additional tax he would have paid if the income had been distributed currently by the trust rather than accumulated. If the throwback rule applies, the beneficiary is taxed not only on the distribution in excess of the distributable net income of the trust, but also on the tax paid by the trust on the accumulated income distributed. The beneficiary then gets a credit for the taxes paid by the trust. In other words, you gross up the amount received by the amount of the tax.

The throwback rule does not apply unless the amounts distributed exceed the distributable net income by more than $2,000. There are other exceptions to the throwback rule, most notably an exception for final distributions made more than 9 years after the creation of a trust.

(5) The fifth point which I think should be kept in mind with respect to existing law is that where a trust or estate has several beneficiaries, problems arise as to the allocation for tax purposes of the distributable income of the trust among the beneficiaries, particularly where the distributions of the trust exceed its distributable net income or where, under the terms of the trust instrument, part of the trust income is accumulated, but corpus distributions are made by the trust. In order to determine the beneficiaries who are to be regarded as having received taxable income and the extent thereof, Congress in 1954 provided a system of priorities in the allocation of income of estates and trusts, commonly referred to as the two-tier system.

Under this rule, the distributable net income of the trust or estate, which by and large is taxable to the beneficiary receiving it, is allocated first to the beneficiaries to whom income is required to be distributed currently under the terms of the trust instrument (the so-called first tier beneficiaries).

If there is any distributable net income left over, this remaining distributable net income is then divided among all other beneficiaries who have received distributions of either corpus or income. These latter beneficiaries are referred to as second tier beneficiaries.

(6) This tier system, standing alone, might give an inequitable result in any case where a single trust with several beneficiaries provides a well-defined separate share for each beneficiary. For this reason Congress, in 1954, also added the so-called separate share rule to the code.

In essence, this rule, which applies only to trusts and not to estates, provides that substantially separate and independent shares of different beneficiaries in a single trust shall be treated as separate trusts for purposes of determining the tax incidence of distributions by the trust.

Turning now from this brief review of present law to the provisions of the measure pending before the committee, I should first like to discuss section 101 of the bill which relates to the sale of property subject to a legal life estate.

Section 101. Legal life estates

This section is intended to prevent income from escaping taxation through a loophole which it appeared had been opened by the decision of the Court of Appeals for the Ninth Circuit in *Cooke* v. *United States*, 228 F. 2d 667 (1955). In that case, the court held that the owner of a legal life estate in certain stocks, where there was no liability for waste, was not subject to tax either individually or as a fiduciary for the remainderman upon gain realized on disposition of the securities.

In an opinion handed down the eighth of this month in *de Bonchamps* v. *United States*, the Court of Appeals for the Ninth Circuit expressly overruled its position in the *Cooke* case by holding that property held subject to a legal life estate should be treated for tax purposes as property held in trust and that the life tenant is liable as fiduciary for payment of tax on capital gains of the trust. This decision follows recent decisions of the Court of Claims and the District Court for the Southern District of California, which also held the life tenant responsible for the capital gains tax as a fiduciary.

Senator FREAR. Mr. Glasmann, did the composition of the court change in the meantime?

Mr. GLASMANN. I do not believe the composition of the court changed materially. The first decision was by a three-man court and the later decision was en banc with the full court sitting. I believe the decision was 7 to 2 in terms of the judges.

I might say, this later decision by the ninth circuit, as well as decisions by the Court of Claims and district courts of California, seem to have removed the need for the corrective legislation contained in section 101 of the bill, at least for the present time.

Senator FREAR. The Senator from Utah.

Senator BENNETT. What you are telling us, then, is that the effect of the bill would have been the same as the effect of the de Bonchamps decision?

Mr. GLASMANN. The decision of the court in the *de Bonchamps* case seems to be pretty much in line with what the bill would provide, and it would seem unnecessary to have the legislation passed with the case law in its present posture.

Senator FREAR. But you see no reason why section 101 should not be passed?

Mr. GLASMANN. Well, it is a little complex, Mr. Chairman. It may be that it could stand further review, further study, and with the

courts having taken care of the problem pretty well, I think it might be well to defer action on this section until it is studied a bit more.

Senator TALMADGE. What makes you think the judgment of the circuit court of appeals would be upheld by the Supreme Court in its present form?

Mr. GLASSMANN. I do not believe there is a conflict at the present time.

Senator TALMADGE. But that does not constitute a precedent for the entire country, does it?

Mr. GLASSMANN. There are two decisions that you can regard as a precedent now. One would be the decision by the Court of Claims which held along the same lines as the court in the ninth circuit in de Bonchamps, so there are two cases which hold the life tenant liable for the tax as a fiduciary for the remainderman.

Senator TALMADGE. That is contrary to the *Cooke* case.

Mr. GLASSMANN. Yes, sir; with the court deciding the *Cooke* case overruling its decision.

Senator TALMADGE. Was the decision to the *Cooke* case appealed?

Mr. GLASSMANN. No; it was not.

Section 107. Tier system

As I have mentioned, the present law provides a two-tier system for determining which of the beneficiaries receiving distributions from an estate or trust are deemed to have received its "distributable net income" and are thus subject to tax upon the distributions.

Under this two-tier system, beneficiaries receiving discretionary distributions of current income are placed in the same tier (the second) with beneficiaries who can receive only corpus. Thus, a beneficiary entitled to receive only corpus under the terms of the trust instrument may be taxed on a portion of the amounts he receives even though the distributable net income was, in fact, only sufficient to satisfy the distributions to the income beneficiaries.

To correct this and other inequities produced by the present tier system, the bill would revise the classification of beneficiaries under the present two tiers and add a third tier, primarily for those beneficiaries who can receive corpus only. Section 107 of the bill would establish the following order of priority for taxing distributable net income to the beneficiaries of a trust or estate:

First tier: Beneficiaries receiving mandatory or discretionary distributions which can be paid only from current income.

Second tier: Beneficiaries entitled to receive discretionary distributions which may be paid out of either current income or corpus (including accumulated income of prior years).

Third tier: Beneficiaries entitled to receive distributions only out of corpus or accumulated income.

It should be noted that enactment of the proposed change in the tier system, while logically sound, will necessarily mean that some beneficiaries of existing trusts and estates will be taxed more and others less than would be the case under the present law.

Senator FREAR. But do you not, Mr. Glassmann, provide in this third tier, by adding the accumulated income, a disparity between the first and second tiers, even though the first tier is limited to current income only, and the second tier takes in corpus and current income, but no accumulated income?

Is it not possible for a manipulation of the estate or trust to take benefit taxwise by having accumulated income under the third tier?

Senator BENNETT. But, Senator, the second tier does include accumulated income.

Senator FREAR. Yes; but suppose they do not want to use it under that area for tax purposes and want to relate it to put it in the third tier; it is possible for them to do it, is it not?

Mr. GLASMANN. Yes. The tier system merely decides which of the beneficiaries that receive amounts from the trust are to be taxable. For example, if you had trust income of $10,000, and you had a requirement that half of the income be paid currently to beneficiary A, he would always be taxable upon $5,000 because he would be a first tier beneficiary.

If you had a provision that said the remaining income can either be accumulated or paid over to beneficiary B, and it was accumulated, the trust would be taxable on that income that was accumulated.

If, in addition, you had a provision in the trust instrument which allowed some corpus to be paid to beneficiary C and during the year that you accumulated half of the income for beneficiary B, the trust also paid out, say, $2,000 of corpus to beneficiary C, beneficiary C would be taxable upon receipt of that corpus, would pay tax on that as ordinary income, because under the tier system, distributions are regarded as taxable income to beneficiaries, whether characterized as income or corpus by the trust instrument, so long as the distributions of the trust do not exceed the distributable net income of the trust.

Senator FREAR. But they are only taxable when they are distributed?

Mr. GLASMANN. That is right.

Senator FREAR. The beneficiary does not pay tax until he receives it?

Mr. GLASMANN. That is right.

Senator FREAR. And if a case should be where the beneficiary would not desire to have the accumulated income paid in a certain year, it could leave it until a year when the tax was more favorable to the beneficiary?

Mr. GLASMANN. Certainly that is quite a typical situation where you have trusts set up to accumulate income for beneficiaries with payment over at some later date.

Senator FREAR. You feel that that is all right then?

Mr. GLASMANN. Well, later on in my statement I will make some remarks on the possible inadequacy of the present throw-back rule for handling that particular problem.

Senator FREAR. All right.

Sections 102 and 106. Charitable beneficiaries

Mr. GLASMANN. Two important provisions in the bill relate to the treatment to be accorded charitable beneficiaries of estates and trusts. These are sections 102 and 106 of the bill.

The first would bring about a major simplification in the law by treating charitable contributions as distribution deductions rather than as deductions from gross income, as is provided under present law. This change would eliminate the need for two separate sets of computations and numerous complex adjustments in preparing fidu-

ciary returns where there are distributions to both charitable and noncharitable beneficiaries.

The second major change involving charities has to do with their place in the tier system for purposes of determining when charitable contributions shall reduce distributable net income. The bill, in effect, places charitable beneficiaries in a fourth or last tier, so that charitable distributions cannot reduce the distributable net income allocable to, and hence taxable in the hands of, noncharitable beneficiaries, including beneficiaries in the third tier who can under the trust instrument receive only corpus distributions. The stated purpose of this provision is to eliminate opportunities for tax avoidance through the mixing of charitable beneficiares and individual beneficiaries in the same trust.

For example, under present law if a grantor sets up a trust with all of its income required to be paid to his son and an equal amount of corpus is required to be paid University X, the son will be taxed on the full amount he receives as a first-tier beneficiary. On the other hand, if the provisions of the trust instrument are reversed, with all of the income payable to University X and an equal amount of corpus payable to the grantor's son, the son would not be taxable at all.

Senator CURTIS. May I interrupt?

Senator FREAR. Senator Curtis.

Senator CURTIS. Is there a gift tax imposed in that illustration when the trust is created?

Mr. GLASMANN. There may or may not be, depending upon the prior gifts of the grantor.

Senator CURTIS. But assuming that all of the deductions have been used up, and he sets up a trust, and in so doing he exceeds his deductions.

Mr. GLASMANN. There would be no gift tax imposed with respect to the amount set up in trust for charity. You have a deduction in computing your taxable gifts—

Senator CURTIS. I am speaking in behalf of the son.

Mr. GLASMANN. Yes; there would be a gift tax imposed on the half given for the son.

Senator CURTIS. Under this new rule proposed, there could be a circumstance where if that corpus is turned over to him, it is treated as income?

Mr. GLASMANN. That is true under the tier system of existing law.

Senator CURTIS. But a gift is not income, is it?

Mr. GLASMANN. In 1954, when Congress made the revision to subchapter J, it put subchapter J in the Code, it was recognized if you were to allow the labels used by the grantor of a trust to determine the tax consequences to the beneficiaries of amounts received, you would have a tax avoidance situation. Congress therefore adopted the tier system approach and the distributable net income concept to meet this problem. Thus, under present law amounts coming out of the trust are taxable to the beneficiaries receiving them regardless of whether characterized as corpus by the trust instrument if the trust has distributable net income and if prior beneficiaries in higher tiers have not already received amounts in excess of the distributable net income.

Senator CURTIS. In this illustration used there, let us assume that the university gets all the income and that there is no accumulation for the son. Under existing law, it would still be taxed to him as—

Mr. GLASMANN. That is what I was pointing out. Under existing law if you reversed the situation and all of the income of the trust were payable to University X with an equal amount of corpus payable to the son, there would be no income tax imposed upon the son upon receipt of distributions from the trust.

Senator CURTIS. Yes. Now, what you propose to do is to treat it as income?

Mr. GLASMANN. The Ways and Means Committee felt that was a tax avoidance situation. I might say that the advisory group also did, and recommended that a change be made in this area.

Senator CURTIS. Yes. Thank you.

Mr. GLASMANN. Under the bill the grantor's son in both situations would be taxable on the amount received from the trust, without regard to whether the amount he received was characterized as income or corpus under the trust instrument. This result would be accomplished by dropping the charity down to the bottom rung of the tier system ladder, so that the distributable net income of the trust will always be allocated first, to the extent thereof, to amounts paid to taxable beneficiaries. While controversial, the proposed change in the tax treatment accorded distributions to charity is neded to prevent manipulation of charitable beneficiaries to the advantage of individual beneficiaries through operation of the tier system.

Senator FREAR. Do you think that will have any effect on the establishment of trusts for the establishment of charities? Do you think that people will think rather than set up a trust or estate where charity can have an advantage they would be less inclined to do so? Is there any other way that they could pass on to their sons or heirs or beneficariers the like amount without being subject to the proposed tax?

Mr. GLASMANN. Take the example of a man who makes a will and leaves an outright gift to his son or a gift payable in no more than three installments. Those amounts when paid to his son will not be taxable to the son even though the estate may have undistributed income. Those are exceptions that are now in the law.

If, however, he wants to have the son receive payments over an extended period of time more or less as an annuity, the son would be taxed under existing law with respect to such distributions if there were accumulated and undistributed trust income, unless you combine your gift in trust with a gift of all the income either to be paid or accumulated for charity. It is that latter situation that is looked at as a tax manipulation situation.

Senator FREAR. In the last example that you used, if the beneficiary, as used in this case, the son, was not given X dollars but given the entire income of the estate year by year, would not the maker of the estate or trust fare just as well in passing on his estate to his heirs by doing it directly rather than the charities getting any benefits from it?

What I am trying to determine in my own mind is: Is it going to be more advantageous to a person making his will into an estate or trust for benefit of his heirs and so forth directly without having

the present advantages of going through the charitable part of this, and having charities get a part of his estate without a distinct disadvantage to the heirs.

In other words, I am sure it is more complicated and I did not intend to make it that way and it is purely by accident that I did, but if a maker of an estate or trust can conceivably legally grant to charities certain income without a direct disadvantage to his heirs, he would be more inclined toward giving consideration to some income for charities than he would if there is no benefit to the charities and no penalty to the beneficiary?

Mr. GLASMANN. Well, it is entirely possible under existing law and under the bill as it now stands for a man to leave gifts in trust for charity, let us say the charity is the only beneficiary, the income of the trust would not be taxable. The man making the gift would be allowed a charitable deduction, if he made the gift during his life, in computing his income tax.

Senator FREAR. Is that entire income going to a charity or divided?

Mr. GLASMANN. I am thinking now of a trust set up with just a charitable beneficiary.

Senator FREAR. Yes.

Mr. GLASMANN. If you take $100,000 and you say the man wants to leave $50,000 plus the income from the $50,000 to his son and he wants to leave $50,000 plus the income from the $50,000 to charity, if he sets up two trusts, each with separate beneficiaries, one charitable, one his son.

Senator FREAR. Yes.

Mr. GLASMANN. The son is only taxable upon the income from $50,000 in that situation. If he combines the gifts in one trust under the bill, the son might very well end up being taxable upon all the income. So that the bill would tend to discourage making combined gifts to individual beneficiaries and to charities in the same instrument.

Senator FREAR. But there is a solution by making two trusts?

Mr. GLASMANN. There is a solution by making two trusts and if the committee did not want to go quite as far as the bill goes, you could take the approach that the advisory group did, which would be instead of dropping the charity down into a complete bottom tier, the fourth tier, to put the chariy up in the third tier with the corpus disributions to noncharitable beneficiaries. That would tend to be a more modest approach to correcting what might be regarded as an abuse under present law.

Senator FREAR. Thank you. You certainly made it clearer to me and I hope the Senator from Utah does not confuse me now.

Senator BENNETT. I am not going to confuse you, I hope. Why not a simple provision in the law forbidding the mixing of private and charitable contributions in the same trust.

Mr. GLASMANN. I would doubt, Senator, whether you would want to go that far. What would be the penalty if you did have such a mixing? I would think the better solution would be to handle charitable beneficiaries under the tier system by either placing them in a bottom tier by themselves or in the third tier with other noncharitable beneficiaries.

Senator BENNETT. I am a little puzzled. To start with, if you had a single trust, the grantor putting money in trust to his son, and providing that he shall receive the income which is then taxable to him, how is the corpus, how is it possible ever to transfer the corpus to the son without making that taxable to him?

Mr. GLASMANN. Presumably, the trust instrument would also have a provision which would allow the trustee to distribute in his discretion certain amounts of corpus to the son. To the extent that the distributions of income of the trust were equal or exceeded the distributable net income of that trust, the corpus could be distributed to the son without any further tax consequences.

Senator BENNETT. Well, it seems to me if you leave this in the tier system, you inevitably doom the son to pay taxes on the distribution of the corpus, provided that if you distribute the income to the charity——

Mr. GLASMANN. If you have the charity in the bottom tier, that is true.

Senator BENNETT. It would seem to me the simplest way out is to keep them separate from the beginning and to force the separation because as long as you permit it, you tend to give the charity a benefit at the expense of the son. And I do not think that is too smart.

Mr. GLASMANN. I think probably the person getting the benefit would either be the grantor by being able to give more to charity than he otherwise would be able to, or by being able to leave more to his son than he otherwise would be able to because of the fact that by arranging the trust instrument in such a fashion as to make the charity the recipient of the income, he would avoid any further tax upon distribution of amounts to his son. So that the benefit probably flows in any one of three directions under existing law, and the damage comes in not having a tax collected at the beneficiary level upon any of the amounts distributed by the trust.

Senator CURTIS. Where the trust accumulates for some time and there is no distribution and the trustee makes a tax return, he only gets $100 a year personal exemption; is that correct?

Mr. GLASMANN. That is right.

Senator CURTIS. And that is only $100 even though the grantor has only created one trust for the child and the child is only the beneficiary of one trust; is that right?

Mr. GLASMANN. That is right. As long as you have an accumulation trust, a trust accumulating income, the personal exemption of that trust would be limited to $100 a year.

Senator CURTIS. And that was changed in 1954, was it not?

Mr. GLASMANN. Yes. A trust which is required to distribute its income currently is allowed a $300 exemption wherever trusts which accumulate income are limited to a $100 exemption.

Senator CURTIS. Prior to that it was the same as the personal exemption, or was it $300?

Mr. GLASMANN. I believe it was $300. I don't recall for sure.

Senator CURTIS. But the lowering of it was for the purpose of taking care of abuses where a great many trusts——

Mr. GLASMANN. I believe the lower personal exemption in the case of trusts which accumulated income was part of a combination of approaches taken to try to reduce somewhat the abuse that was thought to exist in the case of trusts accumulating income.

Another of the changes was, of course, the 5-year throwback rule which I mentioned.

The next section that I would like to discuss——

Senator CURTIS. I do not want to delay it long, but I remember some of those— Mr. Stam just called my attention to the situation where one man set up a thousand trusts with the same beneficiary for the benefit of personal exemption but on the other hand, this low personal exemption of only $100 does make a rather severe and harsh tax in some cases. I have in mind a friend of mine who upon the birth of a grandchild or a niece or a nephew, he creates a trust of a rather modest amount, that in his opinion would accumulate at age 18 to a reasonable contribution for college education, and that particular child is not the beneficiary of any other trust whatever. Yet that tax starts at a $100 exemption.

Mr. GLASMANN. Yes. I think you can develop situations that would seem harsh under that rule. But take the other situation where you have a beneficiary who already has $10,000 or $20,000 of income of his own and you set up a trust for him and the trust is accumulating income which is taxable to that trust as a separate entity. You have a split income situation that is very advantageous, and to allow a high personal exemption in that situation just adds to the difficulty.

Senator FREAR. But the exemption only applies to income, does it not? The exemption applies only to income?

Mr. GLASMANN. That is right.

Senator TALMADGE. Would not the beneficiary pay income tax on the two total sums, one from the trust and his individual income when he received it?

Mr. GLASMANN. Not necessarily. There are a number of exemptions to the 5-year throwback rule which would make it possible for the beneficiary to receive all the income accumulated by the trust without having any further tax imposed upon him when he receives that income.

Senator CURTIS. When the trust is entirely on a cumulative basis and nothing is distributed under its terms, the trustee then reports the tax, not the beneficiary?

Mr. GLASMANN. That is right. The trust is taxable as a separate entity and taxable as an individual.

Senator CURTIS. Yes.

Section 108. Separate share rule and distributions in kind by estates

Mr. GLASMANN. The next section that I would like to take up is section 108 of the bill. This section would extend the separate share rule to estates and would adopt a "distributions in kind" approach in connection with certain distributions by estates. These changes, although criticized by some as not being as broad as they might like, actually go a long ways toward correcting the major problems and hardships now encountered in the taxation of distributions by estates.

The problem areas under existing law which have resulted in widespread dissatisfaction with the handling of estate distributions can be illustrated by two examples.

First, suppose a testator leaves half of his estate to his son and the other half to a marital deduction trust for his widow. If, during the probate of the estate, the executor makes a partial distribution of corpus to the trustee in order to establish the widow's trust, without

making a similar distribution to the son, the trustee for the widow will have to pay a tax on a disproportionately large amount, if not all, of the income of the estate even though half of the estate's income has been accumulated for the son and must eventually be paid to him. The extension of the separate share rule to estates, as proposed in section 108 of the bill, would limit the tax on the trustee, under the facts in the example, to the income attributable to the widow's separate one-half interest or share in the estate.

The second example involves the case where the executor distributes the family automobile from the residue of the estate to the widow. Since existing law generally treats as a tax-exempt distribution of corpus only those distributions by the estate which are gifts or bequests of definite sums of money or specific property, the widow would realize taxable income upon receipt of the family car. Under the "distributions in kind" approach adopted in the bill, real property or tangible personal property owned by the decedent at death could be distributed from the decedent's residuary estate to his beneficiaries free of income tax if the executor designates the distribution as being in satisfaction of a bequest or devise.

Here again it should be noted that the proposal in the bill differs materially from that recommended by the advisory group, which in substance was that Congress should reenact, with minor changes, the rule of law which existed under the 1939 code. In effect, the advisory group proposal would permit the executor for a period limited to 3 years to determine whether, and to what extent, a distribution by the estate would be taxable to the beneficiary.

Section 103(b). Corpus items of deduction

Under present law expenses of an estate or trust which are charged against corpus are allowed, in effect, as deductions to the income beneficiaries even though the economic burden of the expenses falls on the remaindermen. This rule applies even where there is income allocable to corpus which is taxable to the estate or trust against which these expenses could have been allowed as deductions. This result has been severely criticized as improperly depriving the remaindermen of the benefit of tax deductions to which they are rightfully entitled.

To remedy this situation, section 103 of the bill provides that corpus deductions shall first be applied against income which is allocable to corpus and taxable to the trust or estate. Only the excess of corpus deductions which the trust cannot use to offset corpus income are permitted to benefit the income beneficiaries. The amendment will continue the policy of present law to avoid wastage of corpus deductions and, at the same time, will result in more equitable treatment of the remaindermen with respect to deductions chargeable against corpus.

In this connection it should be noted that under the bill where an estate or trust uses the alternative method under section 1201 to compute its tax on capital gains, the corpus deductions (which would have been allowed the trust if the alternative tax were not applicable) are not allocated back to the income beneficiaries.

It has been stated by the advisory group and others that this results in a wastage of deductions where the alternative tax is used by the estate or trust. We do not think that there is any wastage of de-

ductions in any realistic sense in this situation since the overall tax on the estate or trust is less than it would have been if the corpus deductions had been taken and the capital gains subjected to the regular rate.

Moreover, if the corpus deductions were permitted to go over to the income beneficiaries when the alternative tax applies, the executor or trustee might be subjected to pressure by the income beneficiaries to realize more capital gains as the capital gains of the estate or trust neared the point where the alternative tax would become applicable.

Section 113. Multiple trusts

Section 113 of the bill is designed to limit the tax avoidance opportunities existing under present law in connection with the use of the multiple-trust device. Basically, the multiple-trust problem arises when a grantor creates more than one trust to accumulate income for the same ultimate beneficiary. The tax advantages offered by the use of multiple trusts are twofold:

First, the splitting of income at the trust level among a number of separate taxable entities and, second, the avoidance of tax at the beneficiary level through multiplication of exceptions to the 5-year throwback rule.

Some of the more flagrant cases that have come to the attention of the Internal Revenue Service in recent years have involved the establishment of between 90 and 200 trusts by the same person to accumulate income for the same beneficiary. More typical is the situation where an individual, either all at one time or over a period of years, will establish from 2 to 10 trusts to accumulate income for the same beneficiary.

The substantial tax savings to high-bracket taxpayers that may result from the use of the multiple-trust device is illustrated by the following example: Suppose an individual in the 90-percent tax bracket wants to make a gift of $1 million worth of securities yielding a return of 4 percent to his son, who prior to the gift has taxable income of $20,000. If the gift is made directly to the son, the annual income from the securities, amounting to $40,000, would be added on top of the son's regular income and, if he were single, would be taxed at an effective rate of about 65 percent. If the $1 million worth of securities were transferred to a single trust established to accumulate income for the son, the income would be taxed to the trust as a separate entity at an effective rate of around 40 percent. If multiple trusts, rather than a single trust, were used to accumulate income for the son, the tax savings may be materially increased. Thus, if the grantor established five trusts to accumulate the income for the son, the effective tax rate on the $40,000 of income, divided equally among the five trusts as separate taxpaying entities, would drop to around 24 percent.

Moreover, because of the many exceptions to the throwback rule provided by existing law (particularly the termination exemption for trusts lasting more than 9 years), it would be a simple matter for the grantor to arrange his five trusts so as to avoid any additional tax on his son at the time the accumulated trust income is distributed to him.

While in a case as flagrant as this five-trust example, the Service might attempt, through litigation, to disregard the separate trust

entities, the example does illustrate the procedure followed by a number of high-tax-bracket taxpayers to obtain tax advantages through the creation of multiple trusts for the same beneficiary.

Incidentally, the example points up the fact that single trusts can also be used to save taxes. This suggests that at an appropriate time Congress should give serious study to tightening for all trusts the application of the throwback rule of existing law.

The problem of multiple trusts has been recognized for a number of years. In 1956, for example, the staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department listed this problem as one of a number of unintended benefits for examination by the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee. The work of the advisory group on subchapter J in the multiple-trust area grew out of this staff recommendation.

A number of different possible ways of dealing with the multiple-trust problem have been suggested. Those who oppose any legislation suggest that there is no proof that the problem is sufficiently widespread to justify complex legislation and that the Service should attempt to control the problem through regulations and litigation.

Others have suggested that a broad statutory provision might be enacted which would simply give the Secretary of the Treasury or his delegate the power to tax multiple trusts as one trust, where necessary, to prevent tax avoidance. Another approach, and basically the one recommended by the advisory group on subchapter J, would provide detailed statutory rules for consolidating the income of all trusts created by the same grantor for substantially the same primary beneficiaries, without regard to the presence or absence of tax avoidance motives.

Still another approach, and the one adopted in the bill to deal with the problem, would tax the beneficiary receiving distributions from multiple trusts at the time the distributions are received. This would be accomplished by expanding and tightening the operation of the throwback rules of existing law where multiple trusts are involved.

Each of the above approaches has its advantages and disadvantages.

As I have mentioned, the approach taken in section 113 of the bill would tax the beneficiaries of multiple trusts upon the accumulated income of such trusts as and when distributed to the beneficiaries. This rule would apply, however, only to the extent that income has been accumulated by a multiple trust in the preceding 10 years.

Moreover, where a grantor creates a series of trusts to distribute the accumulated income to the same beneficiary, the first trust making distributions would not be subject to the multiple-trust rules, but distributions from the second and succeeding trusts would be treated as multiple-trust distributions.

In essence, the bill attacks the multiple-trust problem by eliminating the exceptions under the present 5-year throwback rule and by extending the throwback period from 5 to 10 years. This new 10-year throwback rule for multiple trusts would operate in substantially the same manner as the present 5-year throwback rule except that the character rules would be eliminated and the additional taxes due from the beneficiaries would be computed without the limitation on tax contained in section 668(a) of the Code.

The principal advantages of this approach are twofold:

First, the additional tax is imposed on the beneficiary and only when it is an established fact that the trust is a multiple trust. Thus, as compared to the consolidation approach of the advisory group, it offers more certainty as to the trusts to which it applies and there is no need to develop complex rules for consolidation of trust income or to fix responsibility for making the consolidation.

Second, by tightening and expanding the throwback rule, many of the tax advantages which now contribute to the establishment of multiple trusts would be removed.

The approach taken under section 113 of the bill has been criticized on a number of grounds.

First, it is argued that the throwback approach, by waiting to impose the additional tax upon distributions by multiple trusts, does not reach the savings that occur during the period income is accumulating in the trusts at relatively low tax rates.

Second, it is claimed that the approach creates an unwarranted discrimination between beneficiaries of single and multiple trusts. For example, it is pointed out that multiple trust status, because of the elimination of the character rules, results in the taxation of beneficiaries on amounts which represent accumulated tax exempt income. It is also asserted that it is inequitable to make multiple trust status depend upon coexistence of two trusts rather than coaccumulation of income by the trusts. To cure these problems it has been suggested that the bill might be revised in two ways, first, that trusts would be treated as multiple trusts only if they accumulate income for the same period so that there is some income splitting at the trust level.

Senator BENNETT. Would you mean by that, they must be exactly coexistent?

Mr. GLASMANN. What it would probably mean, Senator Bennett, is that the trust would have to accumulate income in the same year to have distributions from that particular year to be regarded as multiple trust distributions.

Senator BENNETT. But not be identical in the total period over which they accumulate income?

Mr. GLASMANN. No.

It has also been proposed that tax exempt income of a multiple trust should retain its character when distributed to a beneficiary. We believe that these suggestions have considerable merit and that these aand other possible modifications of section 113 should be given careful study.

It is claimed that many of the objections to the throwback approach of section 113 would be satisfactorily met by consolidation of the income of multiple trusts as earned. In other words, multiple trusts accumulating income for the same beneficiary would, in effect, be taxed as one trust. This in substance is the advisory group proposal, although the advisory group would have permitted certain exceptions to its general rule. While the consolidation approach has considerable merit, the major objections to the advisory group proposal are as follows:

(1) Under the proposal the existence of multiple trusts depends upon whether the primary beneficiaries of two or more trusts are substantially the same. Since these terms are vague, it will be difficult

for both taxpayers and the Revenue Service to determine the scope and operation of the statute.

(2) It does not require consolidation of trust income, at least the approach suggested by the advisory group, where the grantor has created three or less trusts and no two were created within 60 months of one another.

Furthermore, testamentary trusts would be treated separately from inter vivos trusts. This three-trust exemption would be, in effect, acquiescence in a three-way income splitting and would blueprint a way for tax minimization.

(3) The advisory group consolidation proposal does not spell out the method of computing the tax in connection with the consolidation of income of multiple trusts, the method of allocating the tax among the trusts, or fix the responsibility as to which trustee shall bring the several trusts together. It has been suggested that matters as basic as computation of tax, allocation of liability for tax and fixing responsibility for consolidating trust income should not be left to regulations without some statutory guidance.

(4) The advisory group consolidation approach does not have any impact upon the foreign source income of a trust established in a foreign jurisdiction, even though the grantor and primary beneficiary are American residents, and the grantor has already established several domestic trusts to accumulate income for that same beneficiary.

As is evident from the above discussion, the multiple trust problem is not a simple one. It is, however, a problem that urgently needs congressional action. In the opinion of the Treasury Department, some form of legislation should be enacted during this session of Congress to prevent existing and potentially serious abuse through the use of multiple trusts.

The Treasury Department prefers an approach to the multiple trust problem along the lines of section 113 of the bill over the consolidation approach suggested by the advisory group primarily because of the greater complexities involved under the latter approach.

If the committee should feel that the throwback approach taken in section 113 of the bill does not provide a satisfactory solution to the multiple trust problem, the Treasury Department would recommend that the committee give favorable consideration to the consolidation approach of the advisory group but with appropriate modifications to insure that all multiple trusts are effectively covered.

If neither approach can be satisfactorily worked out in time for legislative action this year, consideration might be given by the committee to the adoption of an interim or stopgap measure for deterring at least the more flagrant abuses in the multiple trust area.

Senator CURTIS. Would you just take a moment to illustrate the throwback in its operation?

Mr. GLASMANN. You mean the throwback rule of the present law or under the multiple trust provision?

Senator CURTIS. Both. What it is now and how practically the change would affect it.

Mr. GLASMANN. Under existing law, if you have a trust established to accumulate income, we will assume for beneficiary A, there is a rule which provides that when a distribution is made by the trust

which exceeds the current distributable net income, you look to see whether the trust has accumulated income in prior years, and if it has accumulated income in prior years you will also tax the beneficiary upon those past accumulations to the extent that the accumulations do not exceed the amount accumulated in the past 5 years by the trust.

Under the rule, however——

Senator CURTIS. What are you getting at——

Mr. GLASMANN. Let me give you an example. Maybe that would be simpler.

Senator CURTIS. Yes.

Mr. GLASMANN. Assuming you have a trust this year that has $10,000 of income, distributable net income, and that it actually makes a distribution to beneficiary A of $30,000.

You go back to the preceding years to see——

Senator CURTIS. You take 5 years to see whether that is income which has been retained or in reality is——

Mr. GLASMANN. Right. You look at the first preceding year to begin with, and if the first preceding year there was accumulated income—let us assume there was an accumulated income of $8,000 after the trust had paid its tax of $2,000—you would pick up that $8,000 of income and tax it to the beneficiary, add it on to the amount of $2,000 tax that had been paid by the trust so that the beneficiary would be taxed upon $10,000 of income with respect to the accumulation of the trust in the preceding year. He would then get credit against the amount of tax that he would have to pay for the tax paid by the trust.

Senator CURTIS. He pays it in the year at the rates of the current one, the last one?

Mr. GLASMANN. There are two ways that he can compute his tax. Either he can include all the income in the year he received it and compute his tax under those rates, or he can go back and recompute the tax that he would have paid had the income actually been distributed to him in those 5 preceding years, and not pay a higher tax than the amount that would be determined under that alternative basis.

Senator CURTIS. Would he be subject to penalties and interest?

Mr. GLASMANN. No.

Senator CURTIS. You change it from 5 years to 10 years; is that it?

Mr. GLASMANN. That is one of the differences.

Under the existing 5-year throwback, there are a number of exceptions. One of the exceptions is that if a trust is established for a period of more than 9 years to accumulate income, and after that 9-year period makes a distribution in termination of the trust, distributes everything to the beneficiary, the throwback rules do not come into effect at all, so that the beneficiary can receive all that accumulated income without having any additional tax to pay.

Senator CURTIS. That is regardless of what tier it is in?

Mr. GLASMANN. That is regardless of what tier it is in. There is an exception for a termination distribution by a trust lasting more than 9 years.

Now, there is an exception also for accumulation of income during the beneficiary's minority. So that you can accumulate income for beneficiary up to the age of 21 and if it is paid over there is no tax picked up at the beneficiary level with respect to income accumulated during his minority.

The change in section 113, in addition to extending the throwback period from 5 years to 10 years, would eliminate all the exceptions, so there would be no exceptions to the present throwback rule.

In addition, the bill as it now stands would remove the character rule so that you would not pass through tax-exempt income from the trust to the beneficiary.

It has been suggested that that is too harsh and we certainly think there is merit in that contention.

Mr. Chairman, there is one other provision in the estate and trust sections of the bill which I would like to comment on, although it is not covered in my prepared statement, and that is section 110(b) of the bill.

This section would provide an exception to the present 5-year throwback rule for amounts paid to a beneficiary as a final distribution by reason of his reaching a specified age if the trust is created by will or was revocable by the grantor immediately prior to his death.

We are not in favor of this exception because it further weakens the operation of the 5-year throwback rule under the present law. There are many indications that, because of existing exceptions to the throwback rule, single trusts as well as multiple trusts are being used for tax avoidance purposes. For this reason, the Department would suggest further study of the desirability of tightening the throwback rules for all trusts and not merely for multiple trusts alone as proposed in section 113 of the bill.

That completes my discussion on estates and trusts and I will turn to partnerships, if there are no further questions.

Senator BENNETT (presiding). Any questions, Senator Curtis?

Senator CURTIS. I shall not propound them. I have many of them.

Senator BENNETT. So do I.

TITLE II—PARTNERSHIPS

Mr. GLASMANN. Title II of the bill would substantially revise subchapter K, which deals with the taxation of partners and partnerships.

As mentioned at the beginning of my statement, the 1939 Code contained only a few brief sections dealing with partnerships, while the 1954 Code devotes an extensive subchapter to this area. Title II of the present bill, while retaining the basic statutory framework of subchapter K, would make a number of significant changes in existing law.

By way of background, it may be helpful if I outline some of the major features of the present law before commenting on the proposed changes.

(1) A partnership does not pay any income tax. Only its members are taxable in their individual capacities upon their distributive shares of the partnership taxable income, whether or not actually distributed to them. In other words, the partnership acts as a conduit and the partners are treated as having realized their shares of partnership income or sustained their shares of partnership loss directly from the source from which realized by the partnership.

For example, rental income received by a partnership retains its character as rental income in the hands of a partner thus permitting

him to utilize the special character of this income in computing his retirement income credit.

(2) Generally speaking, a partner realizes no income and sustains no loss when he makes contributions to or receives distributions from a partnership.

(3) Specific rules are set forth in the code to deal with a variety of partnership problems such as computing the basis of partnership interests and assets, and choosing and changing partner and partnership taxable years. The statute also provides various alternative ways for handling partnership transactions which, although adding complexity to the law, afford the partners a maximum amount of flexibility.

(4) Although a partnership interest is a capital asset, there are limitations imposed under the so-called collapsible partnership provisions of the code on the extent to which gain realized by a partner on the sale of his partnership interest can be treated as capital gain. The rules in this area, while necessarily complex, are designed to prevent tax avoidance through the conversion of ordinary income items, like uncollected and untaxed partnership income, into capital gain.

(5) Specific rules are also provided in the statute for the treatment of payments made to a retiring partner or to the successor in interest of a deceased partner in liquidation of the partner's interest in the partnership. In substance, payments made for the partner's interest in partnership property are treated as capital payments. Other payments are treated as ordinary income.

With this short introduction to a highly complicated subject, I would now like to discuss briefly several of the partnership provisions of the bill which I believe will be of particular interest to the committee.

Rearrangement of partnership provisions

The partnership advisory group recommended that subchapter K be rearranged to make its provisions easier to understand, particularly in the case of the small partnership. The bill reflects this proposal by grouping in part I of the revised subchapter the provisions likely to be applicable to the great mass of partnerships and by grouping in other parts the various elections and other technical provisions of the law which are likely to apply only to more complex partnerships, or to the unusual transactions of the average partnership.

This does not mean, of course, that the substantive complexity of subchapter K will be reduced by merely rearranging its provisions. In many instances, only a partial picture can be obtained by reading the simple or general rule set forth in the earlier part of the rearrangement. To be certain of tax consequences, in situations which are at all complicated, the lawyer and accountant will still have to refer to the exceptions or more complex rules set forth in the latter portions of the subchapter.

However, many believe the rearrangement will enable persons to grasp more readily the meaning of these partnership provisions. The Department has no objection to its adoption.

Section 702(b). Level for determining character of partnership items

We would next like to comment on a controversial question which was the subject of considerable discussion before the Ways and Means

Committee; namely, at what level is the character of partnership income and deductions to be determined. The existing statutory provisions contain no explicit statement on this point, but the proposed new section 702(b) would provide that the character of all partnership items shall be determined as if realized directly by the partner from the same source from which realized by the partnership.

One of the problems which the new provision is intended to cover is the basis for determining whether gain on a sale of property by a partnership is capital gain where, if sold directly by one or more of the partners, the gain would have been taxable as ordinary income. The example often used to illustrate the problem is the case of a real estate dealer who enters into a partnership with two nondealer investors to acquire and hold real estate which is subsequently sold by the partnership at a profit. There are at least three possible views as to the appropriate factors to consider in determining how such gain is to be taxed to the partners.

The first, which has a number of proponents, is to look solely to the business activities of the partnership. This would permit the real estate dealer to use the partnership to convert ordinary income into capital gain, and does not appear to us to be sound.

The second possibility is to determine the character of gain on sale of a partnership asset by looking primarily to the activities of the partnership, with weight being given in appropriate cases to the activities of a partner who owns a substantial interest in the partnership. Thus, in the example, the fact that one of three partners is himself engaged in the real estate business might be sufficient to taint the partnership. If so, the gain realized on the sale would be taxable to all three partners as ordinary income.

Such a rule has the merit of providing uniform treatment for all partners and, again looking at the example, it would block the flagrant use of partnerships by real estate dealers to avoid tax. But, it should be noted that such a rule might impose an ordinary income tax on some partners who perhaps should be given capital gain treatment while letting others off with capital gain who should be treated as receiving ordinary income.

The third possible approach to this difficult problem, and the one adopted in the bill, after its recommendation by the advisory group, is that the character of the gain be determined at the partner level taking into account for this purpose the activities of the partnership. Such a rule should generally tax as ordinary income to the real estate dealer his share of the partnership gain on the sale.

At the same time, it would allow partners who are not real estate dealers to enjoy capital gain treatment provided the activities of the partnership do not put it in the trade or business of buying and selling real estate. Moreover, just as it is possible for a real estate dealer who is a sole proprietor to have a segregated investment account (sales from which result in capital gain), so also will it be possible under this third approach, where a partnership interest represents an investment account, for sales by the partnership to give rise to capital gain, rather than ordinary income, for the partner who is a real estate dealer. This will be a factual question to be determined in each case.

Section 764(a). Close of partnership year upon death of a partner

Section 764(a) of the subchapter K —

Senator BENNETT. Mr. Glasmann, you missed the statement of the Treasury's position. Did you do that on purpose?

Mr. GLASMANN. No, Mr. Chairman. We certainly favor the approach taken in the bill.

Senator BENNETT. The third approach?

Mr. GLASMANN. Under the previous section, the third approach; yes.

Now, turning to 764(a), this provision is designed to correct an unintended hardship under existing law and merits the special attention of your committee because of its importance to many partnerships.

Under the present law the partnership taxable year generally does not close when a partner dies. This rule was enacted as part of the 1954 Code to prevent the bunching of income where the partnership and a partner were on different taxable years. While the holding open of the partnership year is an equitable rule where a partnership and partner are on different taxable years, it can produce a serious hardship where they are on the same taxable year. Thus, if a partner and his partnership file their returns on a calendar year basis (which is the usual case) and the partner dies, he often loses much of the benefit otherwise arising from deductions, exemptions, and income splitting for the year of his death since none of the partnership income is included in the decedent's final return. The bill would correct this by providing that the partnership year closes for the decedent as of the date of his death, unless his successor in interest, usually his executor, elects to the contrary.

"Simplified" reporting of partnership income

The next section I would like to discuss is section 702(e), which would provide an optional procedure for reporting partnership income. This is the only partnership provision in the bill with which the Treasury disagrees. We would recommend that it be deleted from the bill.

This provision did not originate with the partnership advisory group but was added to the bill by the Ways and Means Committee. The stated objective of the provision is to simplify the reporting problems of small partnerships. We, of course, are sympathetic with the desire to simplify the partnership law and, in particular, the reporting procedures for the smaller partnerships. We have serious doubt, however, that the proposal can accomplish its stated purpose. On the contrary, we are of the view that this additional election will further complicate the law, and may prove to be a tax trap for the unwary partner.

As I previously mentioned, one of the basic characteristics of partnership taxation under the 1954 Code and the regulations is the so-called conduit theory whereby the character of every partnership item of income and deduction which has tax significance carries over to the partners and is reflected as such on their individual income tax returns. Although in most cases this works out to the individual partner's benefit, some taxpayers nevertheless feel that it

is too complicated to keep track of and reflect in their individual tax returns the significant tax characteristics of specific partnership items.

The bill attempts to minimize this problem by providing that where a partnership so elects only a limited number of the items entering into the partnership income account will retain their character when passed down to the partners. Capital gain and loss items, gains and losses with respect to certain business assets, and dividend income would continue to retain their character. All remaining items would be taken into account by the individual partners on their returns as a single, net, ordinary income or loss item.

The suggested change could have the following adverse consequences to the partners of an electing partnership:

(1) If the partnership has rent or interest income, the individual partners will lose the benefit of the rental or interest character of their shares of such partnership income for purposes of computing the amount of their retirement income credits.

(2) The partners will lose the benefit of the additional 20 percent first year depreciation allowance with respect to any depreciable assets acquired by the partnership during any year the election is in effect.

(3) The partners will receive no deduction for partnership charitable contributions, soil and water conservation expenditures, exploration expenditures, and depletion deductions.

(4) Also disallowed to the partners under the new reporting procedure will be any credits (other than those for dividends) attributable to the partnership income.

In view of the heavy price which the partners may unknowingly have to pay for the purported simplification effected by the new reporting procedure, it seems to us that the provision may in fact be harmful rather than helpful. Moreover, the claimed simplification of reporting procedures may be more apparent than real. For example, before making the election under section 702(e) partners and partnerships will still have to ascertain the nature of all partnership income, deductions and credits in order to know whether to make the election.

Furthermore, the new reporting procedure provided under the bill, since it relates only to the determination of the tax liability of the individual partners, would have little, if any, effect upon the reporting problems of an electing partnership. The partnership itself will still have to submit a return showing the nature of all of its income and deductions on the regular partnership return form (form 1065) in order for the Internal Revenue Service to make sure that each partner's distributive share of partnership income does not reflect any of the deductions or exclusions of the type which cannot be passed through to the partners of a partnership making an election under section 702(e).

Section 776. Amounts paid to a retiring partner or a deceased partner's successor in interest

Next I would like to call the committee's attention to some of the changes the bill would make in an important provision of present law dealing with the tax consequences of partnership payments to retired partners or deceased partner's successors. This is proposed section 776 in the bill. The basic function of this section is to help solve the

problem as to how the income of the partnership is to be accounted for when the interest of a retiring (or deceased partner) is being bought out by the partnership.

Present law divides payments to a retiring partner into two categories. The first relates to the amounts paid for his interest in partnership property. These amounts are generally capital payments, which are taxed as capital gain to the retiring partner and are not deductible by the partnership. The second category involves payments which exceed the value of the retiring partner's interest in partnership property. These amounts are taxed as ordinary income to the recipient and are deductible by the partnership.

The bill does not alter this fundamental structure but makes two significant amendments. First, a more equitable definition of partnership property has been developed, with the result that the retiring partner does not pay ordinary income tax upon amounts received for his rights to participate in future services of the partnership or in its future delivery of goods.

Second, a rule has been added which treats all payments to a retiring partner as payments for partnership property, even though the payments exceed the value of such property, if all the payments are made within a 12 month period. This is designed to bring about the result which the parties normally intend where a partner's interest is liquidated by means of a lump-sum payment or a series of payments over a short period of time.

In addition to these important substantive amendments, a number of simplifying and clarifying changes have been made in this section.

Sections 749, 750, and 751. Collapsible partnership transactions

I would finally like to mention briefly some of the more important changes made by the bill in the collapsible partnership provision. This area, which is covered by proposed sections 749, 750, and 751 in the bill, is a highly technical one. However, the collapsible partnership problem can be illustrated by a simple example. Assume that A, B, and C are members of a housing development partnership and that most of the partnership assets consist of fully completed houses which the partnership will sell in the ordinary course of its business. Each partner's share of the partnership income upon the sale of the house is, of course, taxable as ordinary income. Suppose that prior to the sale of the house by the partnership, partner A sells his partnership interest. Under the collapsible partnership rules, A is taxable at ordinary income rates on his share of the unrealized partnership income on the houses, despite the general rule that a partnership interest is to be treated as a capital asset.

You will, of course, note the similarity between the operation of these partnership rules and those which apply when a shareholder sells stock in a collapsible corporation. In addition, just as shareholders in collapsible corporations are prevented from converting ordinary income into capital gains by means of distributions in liquidation of their stock, so under the collapsible partnership rules are partners prevented from accomplishing such result through the medium of partnership distributions.

While the basic pattern of taxing collapsible partnerships introduced in the 1954 code has been retained in the bill, experience has

shown that some modifications are needed. Accordingly, the bill would make a number of changes designed to simplify these complex provisions, to make their operation more equitable, and to close a serious loophole.

As a matter of simplification the bill substitutes for the detailed and troublesome definitions of "unrealized receivables" and "substantially appreciated inventory" a more workable concept of the type of partnership assets which results in ordinary income.

More equity and simplicity is introduced by bringing the collapsible provisions into play only when the partnership has a significant amount of unrealized income items which may be characterized as unrealized receivables. Present law has been criticized because the existence of unrealized receivables in any amount, however insignificant, causes the collapsible partnership rules to apply with respect to the sale of a partnership interest.

As for loophole closing, present law permits taxpayers particularly real estate developers, to circumvent the collapsible provisions by purchasing property with borrowed funds. The bill is intended to close this substantial loophole, but a further modification is needed to carry out its intended purpose.

As I indicated early in this statement, the work of the advisory groups extended over a period of more than 2 years, and their final reports have been before the public since December of 1958. Accordingly, the proposals were initially well considered and there has been an extended period in which professional groups and the public in general have had an opportunity to study and comment on the proposals. Many important improvements were suggested by interested groups and these and other changes have been reflected in the bill which is now before this committee. Witnesses appearing in these hearings may suggest changes which will merit inclusion in the bill. The staff of the Treasury will be glad to cooperate in the development of any changes which the committee deems to be desirable.

Senator BENNETT. Thank you very much, Mr. Glasmann.

Senator Curtis, do you have any questions?

Senator CURTIS. No questions.

Senator BENNETT. Senator Williams.

We appreciate the patience with which you have developed this explanation of the bill to the committee and I am sure we will have other opportunities to have you clear up any questions that may be in the mind of the members of the committee who are not here this morning.

Mr. GLASMANN. Thank you, Senator Bennett.

Senator BENNETT. We will excuse you now.

Our other witness for the day is Mr. Arthur B. Willis, Los Angeles, Calif.

Mr. Willis, I notice from the size of your material, it will take nearly an hour for you to present it. Can you summarize it for us.

STATEMENT OF ARTHUR B. WILLIS, WILLIS & MacCRACKEN, LOS ANGELES, CALIF.

Mr. WILLIS. Mr. Chairman, I do not plan to go over everything in the written statement. The written statement was planned largely for the consumption of the Treasury Department and the staff of the

Joint Committee. There are just about four or five points that I had planned to cover here.

Senator BENNETT. The Senate goes into session at 12 o'clock, and I would hope that we could be through by then.

Mr. WILLIS. I can be through by then, sir.

Senator BENNETT. Fine.

Mr. WILLIS. It will be a question as to the amount of time required by questions. I have at least one proposition on which I would hope that there would be some questions.

Mr. Chairman, the advisory group formally completed its work at the time of reporting to the Subcommittee on Internal Revenue Taxation of the Committee on Ways and Means and therefore we have no formal status——

Senator BENNETT. Were you a member of the advisory group?

Mr. WILLIS. I was chairman of the advisory committee.

Senator BENNETT. Thank you. I think that should be in the record.

Mr. WILLIS. We submitted 22 legislative recommendations, the majority of which have been adopted, many of them verbatim, the balance with some modifications. There were a few modifications and changes with which we do not agree.

I have filed a written statement to which you referred, 28 pages, double spaced. It has a cross index at the end which may be helpful in referring from the provisions in the H.R. 9662, to the recommendations of the advisory group and also to the page at which it is discussed in the written statement.

Senator BENNETT. For the record, this statement will be accepted and printed in the record at the end of your comments this morning.

Mr. WILLIS. I am sure that the committee understands that the comments that are made in the written statement that I shall make today are not submitted with any feeling of partisan advocacy that the recommendations of the advisory group must necessarily prevail. We are all working for the goal of achieving a tax law that will be fairer and simpler in its operation.

Mr. Glasmann has commented on section 702(e), the proposed simplified reporting by partnerships. The advisory group is in accord with the recommendation of Mr. Glasmann, namely, that section 702 (e) should not be added. We, *too*, feel it is extremely doubtful if it will work any real simplification of the tax law relating to partnerships.

We feel that it would be better to leave this, at least for the time being, to the administrative discretion of the Treasury Department. If it should develop as a result of statistics, which are not currently available, that partnerships do not have the multiple classes of income and deduction of credits which must be separately stated, perhaps a simplified partnership return could be prepared only for the classes of items that are most commonly encountered by the small partnership.

We submit that the advisable thing to do is to have a more complete statistical analysis the next time there is a study of partnership tax returns. We feel that if there were information available as to the number of partnerships, in size classifications, which have different categories of income, deduction and credit items, then it would be

possible to approach the problem on a basis that would be truly helpful in simplifying the return form for the small partnership.

The next point is——

Senator BENNETT. What you are proposing is at least two separate forms?

Mr. WILLIS. I think that that is a matter that the Treasury Department has the present authority to do without any statutory enactment. If a study based on the development of statistical information should indicate, for example, that a large proportion of the partnerships with income of less than $10,000, which would constitute a majority of partnerships, only reported ordinary income and gain or loss of depreciable property, perhaps a simpler form could be put out with only those two classifications available for partnerships having only those classifications of income.

Senator BENNETT. Thank you.

Mr. WILLIS. The problem on which we have the greatest difference of opinion between the advisory group and the provisions in H.R. 9662 is the proper price to be paid for simplification. There are two or three areas in the advisory group recommendations where, after a most careful consideration of the problem, we recommended a different statutory approach than under existing law, feeling that it would substantially simplify the whole area of partnership taxation.

In some of these situations we recognized that there was a certain minimum amount of potential tax avoidance resulting from our recommendations. We very carefully considered the amount of the tax avoidance. While I do not profess that we thought of every possible abuse, we did bring into play all of the ingenuity and the skill as practicing attorneys and accountants of the members of the advisory group. We came to the conclusion that there was only a minimal amount of potential tax avoidance, and that minimal amount was not too great a price to pay if, in fact, there was a very significant simplification of the tax law resulting from the proposed legislative change.

Those recommendations were not adopted. We still advance them as being desirable improvements in the tax law, but leave——

Senator CURTIS. Which provisions are you talking about?

Mr. WILLIS. I am going to come to those specifically, sir. I am doing this by way of laying the groundwork. And we would submit that the potential tax avoidance can be restrained so as not to be too great an item.

Now, the prime example of this is section 770 in H.R. 9662, dealing with the transfer of a capital interest in a partnership as consideration for services by a partner.

I might give you a very simple example. The AB partnership has inventory with a basis to the partnership of $9,000 and a fair market value of $12,000. To deliberately simplify my example, that is the only asset of the partnership.

The partnership now proposes to take in C as a partner, and in order to induce him to come in as a partner and to render his services, it is necessary to give him a one-third capital interest in the partnership.

Now, under the advisory group proposal, C would be taxable only on one-third of the partnership's basis of the property which would be one-third of $9,000, or $3,000.

When the partnership subsequently sells the inventory for $12,000, it will have a $3,000 gain, and C will be taxable on one-third of that gain, $1,000 which when added to the other 3,000, makes him subject to a tax on $4,000, of income which is the correct amount of his income.

H.R. 9662 taxes C on the fair market value of his partnership interest. Certainly, as a matter of general tax law, this would be the accepted rule. If a person receives compensation in the form of property other than money, he is taxed to the extent of the fair market value of that property.

However, the advisory group felt there were excellent reasons why in the partnership area this general rule should not prevail. We felt, for example, that if there were only $3,000 of taxable income at the time he received his interest when the partnership subsequently sold the inventory, he would be taxed on the remaining $1,000, and the right result would be obtained. Furthermore it would be the result that a businessman would normally expect.

Secondly, there is greater simplification in the mechanics of the operation. Under the H.R. 9662 approach, if C is taxable on the fair market value of $4,000, it is necessary for the partnership to file an election to adjust basis of partnership property. If the partnership does not file this election, the basis remains at $9,000 and when the partnership subsequently sells the inventory for $12,000, there is still a $3,000 gain. C is taxed on another $1,000. So he is taxed on $4,000, the fair market value at the time he receives the partnership interest, plus $1,000 at a later time, a total of $5,000, which is $1,000 more than the correct amount of taxable income.

I do not feel that we can assume that every partnership, considering the number of small partnerships which do not have adequate tax advice, will know that it is necessary to file an election in order to avoid this extra tax through obtaining an adjustment to the basis of the partnership property. This is another reason why we feel the basis approach rather than the fair market value approach should be adopted.

I might also add that there is no particular problem under the provisions of H.R. 9662 if there is skilled advice available to the partnership.

For example, in the situation that I have outlined, if the partnership agreement recited that C was to receive a capital credit of $3,000, a specific amount rather than one-third of the total capital of the partnership, and in addition, he is to receive one-third of all subsequent partnership profits, we could get, by proper planning the result that the advisory group is recommending. But this, I think, requires an expectancy of sophistication planning under the tax law that is not going to be available to the small partnership.

The same thing can be true in the case of a professional partnership. For example, a law partnership, which may have a relatively small amount of capital reflected on its financial statement may have a fairly substantial amount of accounts receivable for bills it has rendered and for work in process of being completed and not yet billed.

If a person is admitted as a full partner, even though he pays for his partnership interest with respect to the assets shown on the books

of the partnership, it appears to me that he could well be taxable on the present fair market value of the interest that he acquires in the accounts receivable for bills submitted and in the unbilled work in progress.

Once again, unless the partnership files the elections to adjust basis at the time the partnership actually collects the accounts receivable and makes the collections for the work in process, the new partner wil be taxable on his distributive share of partnership income arising from the collection of the accounts receivable and for the unbilled work in process at the time he was admitted as a partner.

I think that the only significant area where there may be significant tax avoidance under the recommendation of the advisor group is where the partnership has capital assets that have a fair market value substantially in excess of the adjusted basis.

Here, for example, it might be possible for the partnership to agree to give to, let us say, a high salaried producer or movie star a capital interest in a partnership, as part compensation for services, when one of the principal assets of the partnership was stock that had a low cost and a very high market value. In that situation, I certainly would agree it is possible for the movie producer or star to eventually realize a capital gain when the partnership sells the stock and the distributed share of the stock is available.

There are two answers to that: One is the tax is still being levied on the correct amount of total ordinary income. It is a question of perhaps a bit of shifting between taxpayers. If this is a serious problem, I would hope that attention would be addressed to this as distinguished from the whole problem of taxing to the service partner the partnership interest at its fair market value which I think creates inequities and real difficulties in the technical handling under the present provisions of H.R. 9662.

Another example of the difference in attitude between the advisory group and the provisions of H.R. 9662 has to do with the so-called collapsible partnership.

Under section 749 of H.R. 9662, it is necessary to fragment the sales price as between section 751 assets, which are assets that will produce ordinary income upon sale, and all other property.

This is required whether or not there is an overall gain or loss in the sale of the partnership interest. The advisory group report would have taxed the selling partner on ordinary income attributable to 751 assets only to the extent that there was an overall gain on the disposition of his partnership interest.

It seems rather odd, certainly it would be to a businessman, that if he had a loss on the sale of his partnership interest, that that loss could be converted into two items: One, a gain on the sale of his interest in section 751 assets, and, two, a larger capital loss in the disposition of his partnership interest. This is exactly what occurs under the House bill.

There is an example of this, incidentally, on page 17 of my written statement which sets out in more detail than I shall attempt at this moment.

Another problem within this same area is the limitation of the fragmentation concept to the case where the gain attributable to 751 assets exceeds $1,000. This is not included in section 749 and H.R.

9662. It is believed that the advisory groups limitation to ordinary income of $1,000 or more before applying this complex fragmentation concept should be adopted. This is recommended as a matter of protection to the small businessman, who wouldn't know how to apply this fragmentation concept, when the income tax differential is relatively insignificant. Also, the recommended $1,000 limitation is more nearly consistent with the provisions in 782(a) in H.R. 9662, that the partnership is not permitted to adjust the basis of partnership assets following a sale of a partnership interest, unless the total adjustment to basis is $1,000 or more.

I might also point out that really the $1,000 limitation will not involve a significant revenue loss, because the percentage limitation in section 751(d) of H.R. 9662 would normally eliminate any ordinary income on the sale of his interest. In the few cases where the percentage would not eliminate ordinary income to the selling partner, we think that the de minimus amount of $1,000 is a reasonable floor to put in the law.

Another significant point in H.R. 9662 is section 750(a) dealing with the non pro rata distribution by partnership having section 751, that is to say, ordinary income assets.

The advisory group recommended the elimination of section 751(b) of the present law, which has a corresponding provision, on the theory that it was too complex to justify its retention. We recognize that in the process of recommending the elimination, there would be a possibility for some tax shifting among the members of a partnership.

We felt that further consideration might well be given to closing down the area of possible tax shifting of ordinary income assets, but that it was worthwhile to have the simplification even at the expense of some relatively small abuse.

Section 750(a) in H.R. 9662 continues the complexities that do exist under the present law, presumably under the theory that the possible tax avoidance through shifting of ordinary income is too big a price to pay for this degree of simplification.

You might turn, if you will, please, just very briefly to the report of the Committee on Ways and Means, pages 86 and 87. We have here an illustration of the operation of the distribution by collapsible partnerships that brings into operation section 705(a). Although the particular hypothetical example is extremely simple, it takes two pages to explain the very complicated concept that there is a constructive distribution of a pro rata share of all partnership assets to the retiring partner and to the other partners and then they make a constructive exchange to get the assets they really want and then the partners who are going to continue constructively contribute back to the partnership. This is a most exotic concept and one that is amazing to the businessman when he is told on the distribution of property to a partner in a collapsible partnership there may not only be gain to the retiring partner but gain to the continuing partnership.

We would certainly suggest strongly that further consideration be given to the complexity that exists in this provision. If it is agreed that it is indeed complex and that it would be desirable to remove it, attention should be given to a cutting down of the serious areas of tax avoidance. For example, we would have no objection if our recommended elimination of present section 751(b) did not apply

to a family partnership. We believe in most other situations the bargaining among the partners would substantially limit the shifting of ordinary income among partners.

There is a similar problem at the time of formation of the partnership. As a matter of fact, under the general rule of section 704(c)(1) of the present law, a partner may contribute inventory having a very low basis and a very high market value. Upon the subsequent sale of that inventory by the partnership, the ordinary income resulting from the sale of the contributed inventory will be allocated to the partners in accordance with their profit and loss sharing ratios. Thus there is a shifting of ordinary income resulting from the sale of the inventory contributed by one partner at the time of the formation of the partnership. I might add in the long run the partners are going to pay the tax on the full amount of the ordinary income of the partnership. Under the advisory group recommendations, there is no possibility of getting a stepped-up basis for these ordinary income assets. It is only a question of possible shifting among the partners of ordinary income.

The next point has to do with section 776(b)(2)(B), which refers to the specification in the partnership agreement of the payment for goodwill. The advisory group recommended that this could be taken care of other than in the partnership agreement. For example, if, following the death of a partner, there was no partnership agreement dealing with the retirement of his interest, there was really nothing objectionable in permitting the surviving partners and the representative of the estate of the deceased partner to agree as to a payment for goodwill.

The Treasury Department, I believe, feels this gives too much latitude in that the parties can determine, after the event, what is the best tax way to make the payment. I feel it gives little additional latitude. If the partnership has sophisticated tax advice, all that is required is a formal technical amendment to the partnership agreement. If they put it in the form of an amendment to the partnership agreement, they can get the result that the advisory group recommends they should be able to obtain without having to have this sophistication to call this an amendment to the partnership agreement.

Section 703(b), and this is the next to the last point that I have, deals with the deduction of organizational expenses of a partnership. This matter is discussed in the written statement. The primary area of difference between the advisory group recommendation and the provisions of section 703 in H.R. 9662 are in the restrictions contained in the House bill on the expenses that may be amortized over a 5-year period.

Under the advisory group recommendations the expenses that can be amortized include not only the expense of preparing the initial partnership agreement but also the expenses of any amendment to that partnership agreement. The House bill would definitely limit the deduction of the expense to the expenses incurred in connection with the first written partnership agreement.

This, I think, is unfair. The partnership may have a written agreement between A, B, and C which merely recites they are partners and that each shall be entitled to one-third of the partnership profits

and no more. Even in that situation, under the House bill, if they became aware of the importance of having an adequate partnership agreement with buyout provisions and they engage an attorney to prepare it, the expenses could not be amortized over this 5-year period.

There is some question in my mind under the House bill as to whether the present provision under the House bill might not be more beneficial to taxpayers than the proposal under the—than what I am proposing.

I am not sure at all but that the amendment to the partnership agreement might not be an immediately deductible item under existing law. There are cases saying the preparation of the initial partnership agreement is not deductible but perhaps the amendment to the agreement is deductible. We feel this should be put in the same category as the cost of preparing the original partnership agreement, and it should be amortizable over the 5-year period.

Senator BENNETT. To clear that up in my mind, if the original partnership agreement had run 4 years before it was amended, you would extend 5 years from the date of the amendment?

Mr. WILLIS. That is right. The additional expense would be amortized over a new 5-year period running from the date of the amendment.

Senator BENNETT. Yes.

Mr. WILLIS. The other point that creates a difference of opinion has to do with the expense of obtaining capital. I appreciate that in both of these areas the Treasury Department and the staff of the Joint Committee are trying to place the partnerships on an analogy with the corporation, and under the corporation provision, section 248, the corporation may not amortize the cost of obtaining capital. The difficulty I have in applying the rule to the partnership area is I do not know how you determine the cost of obtaining capital. There may be a few situations where the clients come in to see me before they have agreed to form a partnership, and perhaps they will not form a partnership unless I can work out something that they will accept as being fair and protective to all of them. In that case perhaps all of the costs of preparing the partnership agreement is the cost of getting the capital because they would not have contributed the capital without that agreement. In another case the clients may come in and say we have formed a partnership and we are going to share profits equally and will you write up an agreement containing all the provisions we want to have. In that situation perhaps none of my fee is perhaps attributable to the cost of obtaining capital. We feel the cost of obtaining capital, at least in the individual experiences of the members of the advisory group, is quite nominal and should not be segregated but should be permitted to be amortized in the same manner as the costs of preparing the partnership agreement. In the few situations, very rare indeed, where you have a limited partnership in which the interests are widely held and perhaps have an over-the-counter trading, as in the case of one or two of the New York syndicates, we have no objection that the costs attributable very definitely to obtaining capital there, such as registration with SEC, and so forth, should be capitalized. We suggest that some consideration be given to a way of extending appropriate relief through this amortization provision to the great mass of partnerships without extending an open door to

the isolated few that would abuse it. I have suggested in the written statement that one approach might be to have a dollar limitation, say, as $1,000 as a maximum amount that could be put into this amortization account and written off over this 5-year period.

The very last point is section 776(c)(3)(B). H.R. 9662 allows a deduction to the partnership of income payments falling within section 776(a) made by a successor of the partnership but only if that successor is an individual who is engaged in a trade or business and is obligated to make the payments. Thus a successor corporation, a successor partnership, or the executor of the estate of the subsequently deceased surviving partner would not be able to take a deduction for section 776(a) payments made, even though there was an assumption of liability, a binding legal obligation, to make the payments, and payments were in fact made.

The advisory group recommended that these payments should be deductible by any successor to the original partnership. We suggested that there should not be also an adjustment to basis. I have suggested in my written statement what I believe is an improvement over the original suggestion of the advisory group to be sure that there is not a double benefit through permitting a successor organization to obtain the deduction for the income payments made to a retiring or deceased partner and also to adjust basis of its assets for the assumption of the liability to make such payments.

That concludes my oral statement. I would like to state at the conclusion, as I did at the outset, that the point which I believe is of major significance here is what price is a reasonable price to pay for simplification. If indeed it is worthwhile to obtain simplification, then I think we must be willing from the Treasury end, as well as from the taxpayer end, to do a bit of giving and taking. We cannot continue to have complex provisions, taking pages, in order to be sure that no one can possibly sneak through a door and get out scot free.

Thank you very much for your attention.

(The prepared statement submitted by Mr. Willis follows:)

STATEMENT OF ARTHUR B. WILLIS, CHAIRMAN, ADVISORY GROUP TO SUBCOMMITTEE ON INTERNAL REVENUE TAXATION, COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, ON SUBCHAPTER K OF THE INTERNAL REVENUE CODE OF 1954

The advisory group on subchapter K submitted a total of 22 legislative recommendations with respect to taxation of partners and partnerships. These recommendations are contained in the revised report dated December 31, 1957, hereinafter referred to as the "Revised Report", and the supplementary report dated December 8, 1958, hereinafter referred to as the "Supplementary Report".

The advisory group has completed its function of recommending to the Subcommittee on Internal Revenue Taxation of the Committee on Ways and Means changes in subchapter K that would simplify the statute and eliminate both tax loopholes and unintended hardships. As of this date, the advisory group has no official status. However, the members of our group, as individuals, have a continuing interest in the improvement of subchapter K. It is for this reason that I am submitting this statement with technical comments and criticisms relating to the proposed partnership provisions contained in H.R. 9662.

Most of the advisory group recommendations are embodied in H.R. 9662. We are gratified that the House of Representatives acted favorably on such a large proportion of our recommendations.

H.R. 9662 contains one proposed change in subchapter K which is not based on an advisory group recommendation. Several of the advisory group recommendations were substantially modified in the bill before you. Some of the advisory group recommendations were considered but not included in the bill. The balance

of our recommendations are included in the bill in substantially the form we recommended.

On behalf of the members of the advisory group, I shall raise technical and substantive objections to certain provisions in H.R. 9662. This is not done in the spirit of partisan advocacy of the advisory group recommendations. Rather, these comments are submitted in the sincere hope, which, I am sure, is shared by the staff of the Joint Committee on Internal Revenue Taxation, the Treasury Department, and the Internal Revenue Service, that the final result will be a statutory framework which is simpler and more equitable in its operation than the present law.

It is the opinion of the advisory group that the partnership provisions in H.R. 9662 represent a substantial improvement over present law. We are hopeful than an analysis of this statement by the technical advisors to this committee will result in modification of some of the technical provisions in that bill. The advisory group favors adoption, as expeditiously as possible, of the partnership provisions of H.R. 9662, with whatever technical changes that might be made after consideration of this statement and comments by other interested parties. We do not wish to suggest, by the extent of this statement, that the areas in which the advisory group takes exception to the partnership provisions in H.R. 9662 are so significant that action on the bill should be materially deferred for further study.

Our presentation is divided into four categories. These are:

1. Discussion of the one partnership provision in H.R. 9662 which has no counterpart in the advisory group recommendations.

2. Comments on the partnership provisions, or omissions of suggested provisions, in H.R. 9662 which represent substantial variations from the advisory group recommendations.

3. Significant variations in the partnership provisions of H.R. 9662 from the advisory group recommendations as to which the advisory group has no further comments.

4. The recommendations of the advisory group which are included in H.R. 9662 substantially in accordance with said recommendations.

Except as otherwise specifically stated, all references to sections of H.R. 9662 are to those sections as proposed to be amended by section 201 of H.R. 9662.

I. THE PROVISION IN H.R. 9662 WHICH HAS NO COUNTERPART IN THE ADVISORY GROUP RECOMMENDATIONS

Section 702(e) in H.R. 9662 provides a partnership election for simplified reporting. A partnership, all of whose members are individuals, may elect a modified form of conduit treatment. If this election is made, each partner will take into account separately his distributive share of the partnership's—

1. Long-term capital gains and losses;
2. Short-term capital gains and losses;
3. Gains or losses from sale or involuntary conversion of property used in a trade or business;
4. Dividends; and
5. The net figure for all other partnership items of income, gain, loss, or deduction.

If the election for simplified reporting is in effect, the partners' distributive shares of the residual items (category 5, above) are not to include any deduction or exclusion which, under any provision of the Internal Revenue Code, is limited to a fixed amount or a percentage of income.

The advisory group gave serious and extended consideration to the problem of simplified reporting of partnership items. It finally decided against a legislative recommendation (other than the suggested rearrangement of the provisions of subchapter K, which has been adopted in H.R. 9662) with respect to simplified reporting. The reasons for this conclusion were:

1. There was inconclusive evidence as to the need for such a provision. The average small partnership probably has only two or three classes of income, gain, loss, or deduction items. Probably the most significant classes are income from business operations and gains or losses from sales or involuntary conversions of property used in a trade or business. The probable third category in frequency in the small partnership is charitable contributions. If the partnership has only two or three categories requiring separate classification, it can disregard the other statutory classifications in preparing its return.

2. The most satisfactory approach, in the opinion of the advisory group, was to leave this matter to the administrative discretion of the Treasury Department and the Internal Revenue Service. If the development of future statistics with respect to partnership returns indicates the need, administrative action could provide for a special return form to be used by partnerships having only items of income, gain, loss, or deduction within specified categories.

3. Any simplified reporting concept has the potential danger of unwarranted tax benefits or detriments.

While fully sympathetic to the problem, the advisory group questions the practical utility of the proposed five-class conduit concept of section 702(e). The enumerated classes probably cover most classes of items, except contributions, that will be encountered in the majority of small partnerships. If this is a correct assumption, section 702(e) will provide little actual simplification in partnership reporting.

The prohibition in section 702(e)(2)(A) against the deduction of any amount which is limited to a fixed amount or a percentage of income may involve a pitfall into which the unwary small partnership will fall. As pointed out in the report of the Committee on Ways and Means (H. Rept. 1231, p. 78), no deduction will be allowed to a partnership engaged in farming operations for its soil and water conservation expenditures. This can be justified as the price of electing simplified reporting, but it may create understandable discontent in its application to members of small partnerships if they fail to understand the price exacted.

Other pitfalls for the unsuspecting lurk in related provisions of the Internal Revenue Code. For example, if the partnership elects under the proposed section 702(e), its partners may not claim the retirement income credit under section 37 with respect to their distributive shares of the partnership's income from interest or rents.

It is recommended that action be deferred with respect to simplified reporting by partnerships. The next study of partnership returns (such as the one prepared by the Treasury Department and Internal Revenue Service for income years ended July 1953–June 1954) should be broadened to include data on the number of partnership returns, by size classifications, reporting various categories of income, gain, loss, or deduction. Such a study will permit a statutory approach that is more likely to be truly helpful to the small partnership.

II. COMMENTS ON THE PROVISIONS, OF OMISSIONS OF SUGGESTED PROVISIONS, IN H.R. 9662 WHICH REPRESENT SUBSTANTIAL VARIATIONS FROM THE ADVISORY GROUP RECOMMENDATIONS

1. Section 703(b). Deduction of organizational expenses

Section 703(b) in H.R. 9662 departs in two significant respects from the recommendation of the advisory group (recommendation 4, pp. 9–11 of revised report).

Under the advisory group recommendation, the organizational expenses of a partnership to be amortized over a 60-month period would include " * * * any expenditure which is incident to—

"(A) the creation of a new partnership.

"(B) the preparation of a partnership agreement for an existing partnership,

"(C) the amendment of an existing partnership agreement, or

"(D) the preparation or amendment of any agreement relating to the purchase or retirement of the interest of a withdrawing or deceased partner."

Section 703(b)(3)(A) in H.R. 9662 would limit the organizational expenses which may be amortized over a 60-month period to any expenditure which "is incident to the creation of the partnership, or for the preparation of the initial written partnership agreement (but not including any revision thereof or substitute therefor)."

It is recognized that the proposed limitations in section 703(b)(3)(A) in H.R. 9662 are premised on analogy to reorganization expenses of a corporation, which must be capitalized and cannot be deducted until the corporation is liquidated. It is submitted that the analogy is not an apt one and that the proposed limitation is unnecessarily restrictive. For example:

1. If there were a written agreement providing only that A, B, and C were partners sharing equally in profits or losses, any expenditure for the prepara-

tion of an adequate partnership agreement would be denied. This is indefensibly harsh in its operation.

2. The increasing awareness of the significance of the provisions of subchapter K is constantly necessitating the revision of existing partnership agreements to adequately provide for such matters as the death or retirement of a partner. When H.R. 9662 becomes law, the substantial changes in the provisions relating to payments to a retiring partner or to the successor in interest of a deceased partner will make it necessary, in many instances, to substantially revise existing partnership agreements which are adequate under existing law. It seems completely fair that the costs of revising the partnership agreement should be amortizable over a 60-month period.

3. The revision of the partnership agreement is completely dissimilar from the expenses of reorganizing a corporation. The revision of the partnership agreement is basically a matter of revision of a contract. There is not the reasonable expectancy of a long-term benefit flowing from the revision of a partnership agreement which is generally attributed to the reorganization of a corporation.

Section 703(b)(3) in H.R. 9662 also would deny amortization treatment for any expenditures "to obtain capital contributions for such partnership or which are incident to the transfer of assets to such partnership." Again it is recognized that the probable origin of this limitation is in section 248 of the present law dealing with amortization of organizational expenses of a corporation.

Except for the unusual case, the expenses of obtaining capital for a partnership are relatively insignificant, at least in the individual experiences of the members of the advisory group. Further, it will be extremely difficult in the partnership case to determine what portion, if any, of the costs of organizing the partnership is attributable to obtaining capital. It is quite different in the corporate case where it is easier to ascertain the legal and accounting fees, filing fees, and other costs attributable to the issuance of capital stock.

If there is concern that, in a few cases, there may be susbtantial expenditures in obtaining capital (e.g., the limited partnership in large real estate transactions where limited partnership interests may be publicly offered), a better approach would be to have a reasonable dollar limitation (perhaps $1,000) of partnership organizational expenses which may be amortized over the 60-month period.

2. Section 764(a). Closing of partnership taxable year for a deceased partner

The sole query of the advisory group with respect to section 764(a) in H.R. 9662 has to do with the closing of the partnership taxable year upon "(2) the date of the first sale, exchange or reduction occurring after his death of any part of the interest of the deceased partner." This is a concept found neither in existing law nor in the advisory group's recommendations.

It is difficult to understand the reason for a different rule with respect to the closing of the taxable year upon a disposition of less than the entire interest of the partner, in the case of a deceased partner, as contrasted with the case of a living partner. It is believed that the most practical approach, in order to avoid the accounting complications of an interim determination of income, is to apply section 764(b)(2) in H.R. 9662 in the case of a deceased partner, as well as in the case of a living partner.

Under present regulations (sec. 1.736-1(a)(6)), a deceased partner's successor in interest receiving payments under section 736 of the present law is regarded as a partner until the entire interest of the deceased partner is liquidated. One aspect of this concept of the partnership continuing is that the partnership year does not close with respect to the deceased partner until his entire interest is liquidated.

It is highly questionable whether the salutary provisions of the present regulations could be continued in effect under proposed section 764(a)(2). The first payment to the successor in interest of the deceased partner which falls under section 776(b) in H.R. 9662 (sec. 736(b) of the present law), presumably would be a reduction of the interest of the deceased partner. Consequently, the taxable year of the partnership would close with respect to the deceased partner on the date of the first payment under section 776(b).

3. Section 770. Interest in partnership capital exchanged for services

Section 770 in H.R. 9662 adopts the recommendation of the advisory group that there should be a statutory provision specifically dealing with the income tax consequences of a partner receiving a capital interest in a partnership in

exchange for his services. Section 770 also adopts the advisory group recommendation that such tax consequences should apply only to the receipt of a capital interest in the partnership. There will be no income tax consequences if the service partner receives only an interest in the future profits of the partnership.

The advisory group recommended, as a limit on the income to the service partner who receives a capital interest in a partnership, an amount equal to his proportionate share of the adjusted basis of the partnership property. Section 770 in H.R. 9662 deletes this limitation so that the service partner is taxed on the fair market value of the capital interest acquired. (Sec. 770(c)(1)(B) in H.R. 9662 provides other limitations in the case where the capital interest was subject to restrictions or limitations on transferability at the time received by the service partner, but these are not pertinent to the present discussion.)

The main objection to the deletion of the limitation of the service partner's income to his proportionate share of the adjusted basis of the partnership property is the resulting confusion between the concepts of a capital interest and a profits interest. If the partnership has inventory that has appreciated in value, the partners would probably regard the service partner's interest in that appreciation as an interest in future partnership profits. However, if the service partner is required to include in taxable income the fair market value of the capital interest acquired for service, he is taxed at that time on his proportionate share of the appreciated value of the inventory.

The problem may be especially acute in the case of a personal service partnership reporting on the cash basis. Thus, a law firm may have accounts receivable and unbilled work in progress at the time an employee is admitted as a partner with a 10 percent interest in profits. Assume that the accounts receivable and the unbilled work in progress have a total fair market value of $50,000. If the new partner receives, without payment by him, an immediate interest in the accounts receivable and unbilled work in progress, which will be realized upon subsequent collections by the partnership, under section 770(c) in H.R. 9662 the service partner will have immediate taxable income of $5,000. A more logical solution would be for the new partner to be taxed on his 10 percent share as collections are made on the accounts receivable and for the unbilled work in progress.

If the service partner is taxed on the fair market value of the capital interest, the excess of the basis for his partnership interest over his proportionate share of the partnership's adjusted basis of its property will be reflected in the partnership's adjusted basis of its property only if the partnership elects under section 780 in H.R. 9662 to adjust the basis of its property. If there is no partnership election to adjust basis of its property, the service partner will be taxed a second time on his distributive share of partnership income when the partnership sells the inventory or collects for the accounts receivable and unbilled services. The complexity and possible unfairness of the proposed section 770 outweigh the theoretically correct concept of taxing a person on the fair market value of any property he receives as payment for his services.

It has been suggested that avenues will be opened for tax avoidance if the taxable income of the service partner who receives a capital interest in the partnership is limited to his proportionate share of the partnership's adjusted basis for its property. It is believed that a policy statement in the Finance Committee's report, implemented by the regulations, will be sufficient to prevent abuse. For example, it could be stated that the limitation on the service partner's income, measured by his proportionate share of the partnership's adjusted basis for its property, was not intended to apply where low-basis and high-value property was contributed to the partnership in contemplation of the transfer of a capital interest to a service partner.

4. *Section 776. Amounts paid to a retiring partner or to a deceased partner's successor in interest*

(*a*) *Amounts treated as ordinary income.*—Section 736(b)(2)(A) of present law provides that payment by the partnership for a retiring or deceased partner's interest in unrealized receivables of the partnership shall be considered as an income payment falling under section 736(a). In lieu of the "unrealized receivables" approach, the advisory group recommended the adoption of a new concept of "income or gain accruable at the date of death or retirement of a partner not previously includible in gross income under the method of account-

ing used by the partnership, to the extent such income or gain would be treated as other than an amount received from the sale or exchange of capital assets," with an exception in the case of the long-term contract method of reporting (recommendation 14, subhead (d), p. 31 of revised report). Section 776(b)(2)(A) in H.R. 9662 continues the concept of unrealized receivables, but with a narrowed definition (sec. 776(c)(4)) as compared with present law. The definition of unrealized receivables as meaning the rights to payment for goods produced or delivered or for services rendered is probably neither as certain in application nor as inclusive (with an exception discussed later) as the advisory group's concept of income or gain accruable "to the extent such income or gain would be treated as other than an amount received from the sale or exchange of capital assets."

The advisory group, in its supplementary report, recommended that payments for a retiring or deceased partner's interest in "other rights to unrealized income" be treated as income payments, "except to the extent that the partners agree that such rights are included in goodwill of the partnership and that an amount is to be paid with respect to goodwill." This would give the partners the right to agree whether payments for such "other rights to unrealized income" should be treated as income payments or property distributions. The advisory group felt that these "other rights to unrealized income" tend to merge into the ordinary concept of goodwill and should receive the same optional treatment. The advisory group felt that the possibility of tax avoidance under its recommendation was not great.

(*b*) *Requirement that the payment for an interest in partnership goodwill be provided in "the partnership agreement."*—The present law (sec. 736(b)(2)(B)) provides that payments to a retiring partner or to the successor in interest of a deceased partner for his interest in partnership goodwill shall not be considered as being made in exchange for his interest in partnership property except to the extent that "the partnership agreement" provides for a payment with respect to goodwill. The advisory group recommended that the statute be changed so that the agreement concerning this matter need not be in the partnership agreement (recommendation 14, subhead (d), p. 31 of revised report). It was felt that the agreement properly could be reached between the remaining partners and the retiring partner or successor in interest of the deceased partner, even though such agreement were not a part of the partnership agreement. Section 776(b)(2)(B) in H.R. 9662 retains the concept of the present law that the tax treatment with respect to the payment for the retiring or deceased partner's interest in the goodwill of the partnership must be covered in "the partnership agreement."

This may be an important point. It is submitted that it is proper to permit the agreement with respect to the tax treatment of payments for the retiring or deceased partner's interest in goodwill to be determined outside of the partnership agreement. This will be of greater importance to the small or medium sized partnership which has not received adequate advice with respect to the tax significance of the buy-sell provisions in the partnership agreement. It is believed that there are no significant tax avoidance implications arising from permitting the provisions of the buy-sell agreement to be agreed upon after the death of a partner or retirement of a partner. Frequently the significance of the problem is not realized until after such an event has occurred.

If deemed important from the viewpoint of sound administration of the tax law, a time limit might be set within which the agreement must be made. Thus, it could be specified that the agreement with respect to the treatment of payments for goodwill must neither be contained in the partnership agreement or in an agreement between the remaining partners and the retiring partner or successor in interest of the deceased partner made within 1 year after the date of retirement or death.

(*c*) *Deduction of income payments by a successor of the partnership.*—Under the present law it would appear that income payments under section 736(a) may be deducted, or treated as a distributive share of partnership income, only by the original partnership as of the date of death or retirement of a partner. If the partnership were terminated by reason of the circumstances stated in section 708(b) of the present law, a successor partnership might not be permitted to continue claiming the deductions, even though it assumed the liability and did actually make such payments. The same question would be raised if the partnership were incorporated, the successor corporation assumed the obligation to make payments to a previously retired or deceased partner, and it actually

made such payments. The advisory group proposed that any successor to the partnership which assumes a binding obligation to make payments under section 736(a) to a retiring partner or to the successor in interest of a deceased partner shall be entitled to deduct such payments and they shall be included in the taxable income of the retiring partner or the successor in interest of the deceased partner (recommendation 14, subhead (g), pp. 32-33 of revised report).

Section 776(c)(3)(A) in H.R. 9662 provides that the retiring partner or successor in interest of the deceased partner shall include in gross income under section 61(a) any amounts falling within section 776(a) that are received from a successor of the terminated partnership. Thus, it would appear that the retiring partner or successor in interest of the deceased partner must include such payments in gross income, whether they are received from a successor partnership, a successor corporation or the executor of the estate of the subsequently deceased surviving partner.

Section 776(c)(3)(B) would allow a deduction for such income payments only if the person making such payments is an individual and, along with other conditions, is operating a trade or business as a sole proprietor. Thus a successor partnership, corporation or the executor of the estate of the subsequently deceased surviving partner who was obligated to and did make section 776(a) payments would not be entitled to deduct such payments, even though they qualified under section 776(a) and were made pursuant to a binding legal obligation.

It would seem, as a matter of fairness and consistency, that if the retiring partner or the successor in interest of the deceased partner is obligated to report payments under section 776(a) in his gross income, regardless of the nature of the successor to the partnership, such payments should be deductible by any successor of the original partnership.

In order to avoid a possible double benefit from such payments by the successor to the partnership, the advisory group recommended that the statutory language permit such deduction "only to the extent that such amounts have not increased the adjusted basis of assets of such person or such person is not otherwise entitled to reduce taxable income as the result of such payment." Another approach, and perhaps a sounder one, would be to amend section 1016 to specifically provide that no adjustment to basis of property shall be made with respect to any assumption of a liability to pay amounts which constitute income payments under section 776(a).

5. *Sections 749, 750 and 751. Collapsible partnership transactions*

(*a*) *Limitations on the fragmentation concept.*—The advisory group recommended several changes in present section 751. First it was suggested that section 751(a) of the present law should be amended to limit the application of section 751 to those cases where there is an overall gain on the sale of a partnership interest, taking into account all assets, both section 751 assets and other assets. Section 749 in H.R. 9662 requires the fragmentation of the sales price as between section 751 assets and other partnership property, without regard to whether there is an overall gain or loss on the sale or exchange of a partnership interest. It is believed that the advisory group recommendation is a more logical one and that it does not afford opportunities for significant tax avoidance. The average taxpayer would be quite amazed to be told that although he had a loss on the sale of his partnership interest, that loss consisted of two elements, namely, an item of ordinary income on the sale of his interest in section 751 assets and a capital loss on the sale of the partnership interest, with the two items netting down to the amount of the loss on sale of his interest. By a provision in a committee report, implemented by subsequent regulations, it could be made clear that this rule of the ordinary income on sale of a partnership interest not exceeding the amount of the gain, if any, on the sale of such interest did not apply in the case where high-basis and low-value property was contributed to the partnership in anticipation of the sale of a partnership interest.

The advisory group also recommended that the fragmentation of gain on sale of a partnership interest shall not apply unless the amount of the gain attributable to section 751 assets exceeds $1,000. This limitation is not contained in section 749 in H.R. 9662. The $1,000 limitation was regarded as a de minimis amount so as to afford some protection to the member of a small partnership who sells his interest without realizing any significant gain attributable to section 751 assets.

There is a logical correlation between the provision dealing with taxation of gain upon sale of a partnership interest and the adjustment to basis of partner-

ship property resulting from the transaction. Section 782(a) in H.R. 9662 provides for an adjustment to basis of partnership property for the difference between the transferee partner's basis of his partnership interest and his proportionate share of the adjusted basis of partnership property, except that no adjustment shall be made for an aggregate amount of less than $1,000.

Assume that the A B C partnership has a balance sheet as follows:

	Adjusted basis	Fair market value
Assets:		
Cash	$3,000	$3,000
Inventory	6,000	9,000
Capital assets	12,000	6,000
Total	21,000	18,000
Capital.		
A	7,000	6,000
B.	7,000	6,000
C.	7,000	6,000
Total.	21,000	18,000

If C sold his partnership interest to D for $6,000, C would have an overall deductible loss of $1,000. Under section 749, C would have ordinary income of $1,000 (attributable to the sale of his one-third interest in inventory) and capital loss of $2,000. However, if the election to adjust basis were in effect (section 780 of H.R. 9662), the adjustment under section 782 would be a negative amount of $1,000 and the partnership would not be entitled to a plus adjustment of $1,000 to the basis of the inventory.

A similar problem exists under present law. Existing regulations (§ 1.755-1 (a)(2)) offer a partial solution. If a partnership desires to adjust basis of partnership property, other than in the usual manner provided in § 1.755-1 (c)(1) of the regulations, it must file with the district director an application for permission to use such other method of adjusting the basis of partnership assets. The district director may permit the partnership to increase the basis of some partnership properties and to decrease the basis of other partnership properties. Thus, in the example given, the district director might grant the partnership permission to increase by $1,000 the basis of inventory and to decrease by $2,000 the basis of capital assets. The regulations make no attempt to establish standards for the exercise by the district director of this discretion.

The cited provision of the regulations is a brave attempt to plug an apparent drafting oversight in subchapter K of the 1954 code. However, it is, at best, a makeshift arrangement. The preferable solution is to properly correlate the statutory provisions dealing with the recognition of gain on sale or exchange of a partnership interest and the optional adjustment to basis of partnership property.

Unless section 749 in H.R. 9662 is changed along the lines suggested by the advisory group, it will be necessary either to change section 782 to provide for this special situation or again to rely upon the regulations to provide a cure of dubious merit for an inadequate technical correlation of sections 749 and 782.

Under present law if the partnership has inventory with a basis in excess of fair market value, a partner selling his partnership interest may not claim an ordinary deduction for his share of the decline in value of inventory. The advisory group recommended no change in this area, largely because of its recommended limitations of gain attributable to sale of section 751 assets to cases where there was a gain on the sale of the partnership interest and where the gain attributable to the section 751 assets exceeds $1,000. If both of these limitations are to be deleted, as a matter of fairness to the taxpayers, consideration should be given to allowing a taxpayer who sells a partnership interest an ordinary loss deduction to the extent of his proportionate share of the excess of the partnership's basis of its inventory over the fair market value of such inventory at the time the partner sells his interest.

(*b*) *Concept of substantially appreciated section 751 assets.*—Under section 751 of present law, a partner realizes ordinary income from the sale of his partnership interest only to the extent of the gain attributable to the sale of his interest in unrealized receivables of the partnership or inventory items of

the partnership which have appreciated substantially in value. Section 751 (d)(1) states that inventory items of a partnership "shall be considered to have appreciated substantially in value if their fair market value exceeds—

"(A) 120 percent of the adjusted basis to the partnership of such property, and

"(B) 10 percent of the fair market value of all partnership property, other than money."

The advisory group report pointed out that there was an unintended loophole in the definition of substantially appreciated inventory which would permit a partner in a partnership engaged in real estate development, where a substantial portion of the cost of partnership property is borrowed, to completely avoid the collapsible partnership provisions and obtain capital gain or the sale of his partnership interest. (See revised report, p. 39.) The advisory group recommended a definition of section 751 assets which referred neither to unrealized receivables nor substantially appreciated inventory. The advisory group's recommended percentage limitation was determined by reference to the sale of the partner's interest and specified that his gain attributable to sale of an interest in section 751 assets must exceed the difference between 15 percent of the amount realized on sale of his interest and his allocable share of the liabilities of the partnership. By bringing into play the liabilities of the partnership in determining the percentage relationship, a potential abuse by real estate developers of the loophole in the present law would not be possible.

Section 751(d) in H.R. 9662 contains a definition of substantially appreciated section 751 assets. It states:

"Section 751 assets shall be considered to be substantially appreciated section 751 assets if their fair market value exceeds—

"(1) 120 percent of the adjusted basis as to the partnership for the 751 assets and

"(2) 10 percent of the fair market value of all partnership property, other than money, reduced by the liabilities of the partnership."

The failure to bring into operation the liabilities of the partnership in the relationship of the fair market value of section 751 assets to their adjusted basis would permit a continued avenue for tax avoidance by the real estate development partnership where a large portion of the investment in its property holdings is obtained from loans.

(c) *Non pro rata distributions by a collapsible partnership.*—Section 751(b) of the present law deals with the income tax consequences of a non pro rata distribution by a partnership which has unrealized receivables or substantially appreciated assets (hereinafter referred to as "section 751 assets"). Where such a distribution occurs, present law provides that the partner (or partners) who reduced his interest in section 751 assets is deemed to have sold such interest in section 751 assets and to have realized ordinary income therefrom. The partner (or partners) who acquired an increased interest in section 751 assets is deemed to have sold or exchanged an interest in other partnership assets and will realize gain or loss (usually capital gain or loss) on the transaction.

The advisory group recognized the theoretical correctness of the concept of section 751(b). However, the theory of a taxable sale or exchange by all partners involves so many complexities, it was felt that the provision should be deleted. The advisory group so recommended. To guard against the use of partnership distributions being employed to convert ordinary income into capital gain, the advisory group recommended other changes in the statute which prevent section 751 assets receiving a stepped-up basis in the hands of the distributee or in the partnership, as the result of any partnership distribution.

This still left the possibility that a non pro rata distribution by a partnership with section 751 assets would be utilized to shift among the partners the amount of ordinary income to be realized on the subsequent sale or collection of the section 751 assets. This was deemed by the advisory group a reasonable price to pay for the elimination of a most complicated provision. It should be added that the advisory group concluded that there was little possibility of a substantial reduction in overall tax liability of the partners, even if there were some shifting among the partners of the liability for tax on ordinary income upon subsequent sale or collection of the section 751 assets.

Section 750(a) in H.R. 9662 is derived from section 751(b) of present law and would continue the concept of realization of income upon a non pro rata distribution by a partnership which has section 751 assets. The proposed technical amendments of section 750(a) in H.R. 9662 are desirable and do not affect the principle discussed herein. The advisory group feels that it is an error to

perpetuate the complexities of existing law and that there should be no recognition of gain or loss, except to the extent provided in section 731, of present law and in H.R. 9662, upon such a distribution.

The advisory group has previously stated its theory and little can be added. The policy decision that the Congress must make is:

1. Is it worthwhile to substantially simplify the statute by eliminating an exceedingly complex provision at the price of allowing the partners some latitude to shift ordinary income among themselves but without thereby converting ordinary income into capital gain?

2. Or is it preferable to stand fast on the theoretically correct concept of recognizing gain or loss to all partners upon a non pro rata distribution by a partnership which has section 751 assets, even though this involves an unbearably complex concept of determining gain or loss? (See, for illustration, example (1) on pages 86 and 87 of the report of the Committee on Ways and Means to accompany H.R. 9662, H. Rept. 1231.)

6. Section 691(e), Income in respect of a deceased partner; Section 1014(c)(2), Property representing income in respect of a deceased partner

Section 691(e)(1) in H.R. 9662 provides that a deceased partner's distributive share of partnership income up to the date of his death shall be considered income in respect of a decedent. This embodies a portion of the advisory group's recommended changes to section 753 of the present law. However, section 691(e)(1) does not adopt the advisory group's recommendation that the amount of the deceased partner's distributive share treated as income in respect of a decedent shall not be reduced by withdrawals from the partnership made by the decedent before the date of his death. This is material in determining the amount of the deduction allowable under section 691(c) for estate tax attributable to the income in respect of a decedent.

As pointed out in the comment of the advisory group (revised report, p. 45), the problem has been covered in the regulations (sec. 1.753–1(b)), but it was felt desirable to establish the point clearly in the statute. If it is felt by the Committee on Finance that our comment is sound but that the matter does not require legislative coverage, it would be helpful if your committee report contained a specific statement to that effect.

A second point covered in the advisory group recommendations relating to section 753 of present law had to do with the basis under section 1014 for a deceased partner's interest in a partnership. If a deceased partner's distributive share of partnership income earned to the date of his death is income in respect of a decedent, the basis of the deceased partner's interest in the partnership is the fair market value at the date of his death, or at the optional valuation date, reduced by the amount representing income in respect of a decedent. This is probably true under present law and clearly would be the case under section 1014(c)(2) as proposed to be amended by section 203(c) in H.R. 9662.

This reduction in basis may deny to a deceased partner a basis for his interest in partnership assets purchased by the partnership before his death by means of reinvesting partnership earnings for the period up to the death of a partner. To avoid this, the advisory group recommended the addition of a statutory provision which would assure the deceased partner receiving a basis under section 1014(a) for the fair market value of his partnership interest at the date of death, or optional valuation date, without reduction for his distributive share of partnership income to the date of death. Consistent with this concept, the basis of the successor of the deceased partner for the partnership interest will be adjusted under present section 705(a) (sec. 763 in H.R. 9662) only with respect to his distributive share of partnership earnings after the date of death.

The advisory group's recommendation was not followed in H.R. 9662. It is submitted that to attain technical correctness in an important area, it is necessary to amend section 1014 by a provision containing the equivalent of the advisory group's recommendation.

7. Section 780. Manner of electing optional adjustment to basis of partnership property

Section 780 in H.R. 9662 adopts a major portion of the recommendations made by the advisory group with respect to the manner of electing optional adjustment to basis of partnership property. The only area of significant difference is a period during which such election may be filed or changed. The advisory group

recommendation would permit the election to be filed or changed at any time prior to the expiration of 3 years after the time prescribed by law for the filing of the partnership return for the taxable year for which the election is filed. Section 780 cuts down the period, within which the election may be filed or changed, to 1 year after the time prescribed by law for the filing of the partnership return for the taxable year for which such election was filed.

The purpose of permitting a longer period within which to make the election to adjust basis of partnership property (or to change that election) is to afford some protection and relief to the partnership which does not realize the significance of the election until after the partnership return is filed. The advisory group felt that the election should be permitted to be made or changed within a 3-year period following the due date for filing the partnership return, since this would normally include the period in which the revenue agent would make his examination of the partnership return. The advisory group felt that frequently the significance of the election would not become known to the partnership until the revenue agent conducted his examination.

The 1-year period proposed by section 780 after the due date for the filing of the partnership return within which the election can be made or changed is an improvement over the present statute, but does not afford sufficient time to give adequate relief to the small or moderate sized partnership which did not realize the tax significance of the election.

III. SIGNIFICANT VARIATIONS IN H.R. 9662 FROM ADVISORY GROUP RECOMMENDATIONS AS TO WHICH THE ADVISORY GROUP HAS NO FURTHER COMMENTS

There are several areas where the partnership provisions of H.R. 9662 differ substantially from the advisory group recommendations for reasons that were both recognized and considered by the advisory group. The final decisions on these matters could have gone either way and when a concept was adopted in H.R. 9662 that differed from the advisory group recommendation, it is only fair to assume that the difference represented carefully considered policy matters.

The advisory group still supports its recommendations in these areas, but feels the time is past for pressing its concept. In each of these situations, it is obvious that the particular provision in H.R. 9662 was adopted after careful consideration of the recommendation of the advisory group. There is nothing further that can be added on these matters to the comments of the advisory group contained in its revised report.

The foregoing applies to the following provisions in H.R. 9662 which varied in a substantial degree from the advisory group recommendations:

1. Section 705(b): Limitations on determination under the general rule of a partner's basis of his interest in the partnership (recommendation 5, pp. 11-12 of revised report).
2. Section 765: Certain sales or exchanges of property with respect to controlled partnerships (recommendation 8, pp. 16-19 of revised report).
3. Sections 704(d) and 746: Limitation on deduction of partner's distributive share of partnership losses (recommendation 18, pp. 43-44 of revised report).
4. Section 788(a)(2): Organizations excluded from the operation of subchapter K (recommendation 22, pp. 52-53 of revised report).

IV. THE RECOMMENDATIONS OF THE ADVISORY GROUP WHICH ARE INCLUDED IN H.R. 9662 SUBSTANTIALLY IN ACCORDANCE WITH SAID RECOMMENDATIONS

The following provisions of H.R. 9662, representing changes from existing law, were substantially in accordance with the recommendations of the advisory group:

1. Rearrangement of the provisions of subchapter K (recommendation 1, pp. 1-6 of revised report dated Dec. 31, 1957).
2. Section 702 (b) and (d): Level for determining character of partnership income and application of limitations (recommendation 2, pp. 6-9 of revised report).
3. Section 702(c): Gross income of a partner (recommendation 3, p. 9 of revised report).
4. Section 706(b): Adoption or change of taxable year (recommendation 6, pp. 13-15 of revised report).
5. Section 708(b): Nontermination of partnership on sale to a person who is a member of the partnership (recommendation 9, p. 20 of revised report).

6. Sections 731 and 732: Extent of recognition of gain or loss on distribution and basis of distributed property other than money (conforming changes) (recommendation 11, pp. 24–25 of revised report).

7. Section 735: Character of gain or loss on disposition of distributed section 751 assets (recommendation 13, pp. 26–28 of revised report).

8. Section 741: Recognition and character of gain or loss on sale or exchange of partnership interest (conforming change) (recommendation 15, p. 35 of revised report).

9. Section 781: Optional adjustment to basis of partnership property in case of distribution of property (recommendation 12, pp. 25–26 of revised report).

10. Section 782: Optional adjustment to basis of partnership property upon transfer of a partnership interest (recommendation 16, pp. 35–37 of revised report).

11. Section 783(b): Special rules for allocation of optional adjustment to basis of partnership property (with some changes because of nonadoption of other advisory group proposals) (recommendation 21, pp. 49–52 of revised report).

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Section number in H.R. 9662	Recommendation number (and page numbers) in advisory group revised report dated Dec. 31, 1957	Page numbers of this statement
Provisions under sec. 201 of H.R. 9662:		
702 (b) and (d)	2 (6–9)	27.
702(c)	3 (9)	27.
702(e)	None	3–5.
703(b)	4 (9–11)	6–8.
704(e)	18 (43–44)	21–22.
705	5 (11–12)	7–8.
706(b)	6 (13–15)	27.
708(b)	9 (20)	27.
731 and 732	11 (24–25)	27.
735	13 (26–28)	27.
741	15 (35)	27.
749, 750 and 751	17 (37–43)	16–22.
764(a)	7 (15–16)	8–9.
765	8 (16–19)	26.
770	10 (20–24)	9–11.
776	14 (28–34) [1]	11–16.
780	20 (48–49)	24–25.
781	12 (25–26)	27.
782	16 (35–37)	27.
783(b)	21 (49–52)	27–28.
788(a)(2)	22 (52–53)	26.
Rearrangement of provisions of subch. K	1 (1–6)	26.
Provision under sec. 202 of H.R. 9662: 691(c)	19 (44–48)	22–24.
Provision under sec. 203 of H.R. 9662: 1014(c)(2)	19 (44–48)	22–24.

[1] See also p. 1 of supplementary report dated Dec. 8, 1958.

Senator BENNETT. Do you have any questions?

Thank you very much, Mr. Willis.

Tomorrow morning we will meet at 10 o'clock. The first witness will be Mr. Laurens Williams, and the committee is in recess until that time.

(By direction of the chairman, the following is made a part of the record:)

FIDELITY-PHILADELPHIA TRUST CO.,
Philadelphia, April 18, 1960.

Senator HARRY F. BYRD,
Washington, D.C.

DEAR SIR: I wish to register a protest against section 106 of the proposed trust and partnership income tax revision bill of 1960—H.R. 9662.

It is my understanding that under section 106 of the proposed bill the grantor of a 2-year charitable trust would be taxed on the income in the year of termination. However, under section 170 of the Internal Revenue Code of

1954 the settler would not be taxed with the income of this type of trust until after the second year, when the corpus reverts to him.

Section 106 of the proposed bill provides that in determining priority for distribution of income, charity is placed in the fourth tier and the grantor of the charitable trust would be placed in the third tier in the year of termination and taxed on all the income for the calendar year even though the income had been paid to organized charitable organizations.

This section, as presently drafted, would discourage the establishment of new charitable trusts. Not only that, but it evidently penalizes grantors of existing charitable trusts.

I am sure all of us realize the importance and need for charitable trusts and, therefore, should appreciate any effort on your part to correct what I believe to be an unintentional situation.

A similar letter has been sent to Senator Hugh Scott and Senator Joseph S. Clark.

Yours very truly,

W. H. QUIGLEY.

WEIL, GOTSHAL & MANGES,
New York, N.Y., April 18, 1960.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Old Senate Office Building, Washington, D.C.

DEAR SIR: I would like to take this opportunity to bring to your attention an inequity relating to individuals on a calendar year basis who are members of a partnership on a fiscal year basis.

If an individual on a calendar year basis severs his membership in a fiscal year partnership, the consequence is that he is required to report more than 12 months of income in 1 year. To take the most extreme case, suppose such and individual severs his connection on December 31, 1959. For 1959 that individual will have to report 23 months of income for Federal income tax pudposes, as follows:

(*a*) His distributive share of the partnership income for the 12 months ended January 31, 1959. You will realize that for tax purposes he is deemed to have received all of this income on January 31, 1959, although as a practical matter he probably received a substantial part of it by way of drawing over the previous 12 months.

(*b*) His distributive share of the partnership income for the 11-month period, February 1, 1959, to December 31, 1959.

Needless to say, with the graduated surtax rates, the burden upon the individual in such a situation is quite heavy. Nor is this a situation that is unlikely to arise. Almost any person who leaves a fiscal year partnership to take a salaried position will face this problem. Even if he leaves the partnership prior to December 31, he will still have 23 months of income since he will have to report his salary for the period from the date he left the partnership to the end of the calendar year in addition to the items mentioned above.

The only possible way to hedge against such a situation is for the individual to adopt a fiscal year himself which coincides with the fiscal year of the partnership. Leaving aside any question of the consent of the Commissioner to such a change, the individual then runs afoul of the provisions of section 443(b)(1) of the Internal Revenue Code of 1954. This section provides that in the event of such a change, the income for the short year must be annualized—that is, the income for the short year must be multiplied by 12, the tax computed, and the result divided by 12.

The result of this annualization requirement can be quite harsh. Assume an individual on a calendar-year basis is a member of a partnership having a fiscal year ending January 31. The individual decides to change to a January 31 fiscal year. As a result, he is required to file a return for the short year: namely, January 1 to January 31, 1959, and to annualize this income. Let us further assume that the individual's sole income was his distributive share of partnership income for its fiscal year ending January 31, 1959, that this amounted to $15,000 after deductions and exemptions, and that the individual

was married but had no children. His tax for the short period would be computed as follows:

(*a*) Income $15,000
(*b*) Annualized $15,000×12) 180,000
(*c*) Tax on $180,000 117,240
(*d*) Tax payable (1/12 of (*c*)) 9,770

For a person to have to pay a tax of $9,770 on a net income of $15,000 is, to put it mildly, a heavy burden.

Section 443(b)(2) purports to provide some relief by allowing a taxpayer in such a situation to recompute his tax after a period of 12 months from the beginning of the short period and then taking a pro rata amount of that tax (i.e., that proportion which the net income for the short period bears to the net income for the 12-month period).

Let us assume that the individual taxpayer described above continues as a partner and has no other income than that derived from the partnership. His income will, therefore, remain at $15,000 for the 12-month period January 1, 1959, to December 31, 1959, since the next partnership distribution date will be January 31, 1960. At the end of 1960, he may then compute his tax on the basis of $15,000, which will amount to $3,620, and obtain a refund of $6,150.

The difficulty with the relief provisions of section 442(b)(2) is that one needs to have the cash to finance the change of taxable year. It seems strange, indeed, that the practical availability of a provision of this kind should be dependent upon the financal condition of the taxpayer. I do not believe that such a situation fits into the basic philosophy upon which our tax laws are predicated.

The argument may be made that the individual in the situation described had a year free of tax when he was originally made a partner. The fact is, however, that he merely postponed his liability to tax; he was not relieved of a year's taxes. Eventually these taxes have to be paid, and, as the law stands now, at higher surtax rates.

I suspect that, in enacting section 443(b) (and its predecessor sec. 47(c) of the 1939 code), Congress never considered the impact of annualization on an individual who derived his principal income from a partnership. In all probability Congress had in mind the situation of an individual who received his taxable income fairly ratably over the year and inserted section 443(b) to cover situations where occasionally a slight variation might arise.

The inequitable situation which I have described can, I believe, be taken care of by the addition of a subsection (3) to section 443(b) reading as follows:

"(3) *Rule in case of partnership income.*—If the gross income of the taxpayer for the short period includes the taxpayer's share of the net income of a partnership for a taxable year ending within the short period, then the following rules shall apply in computing the tax as provided in subsection (1):

"(A) the taxpayer's share of the net income of such partnership shall be excluded and the tax shall be computed as provided in subsection (1);

"(B) the tax shall be computed on the taxable income for the short period, including the taxpayer's share of the net income of such partnership, but without placing such income on an annual basis as provided in subsection (1);

"(C) the tax shall be computed on the taxable income for the short period, excluding the taxpayer's share of the net income of such partnership, but without placing such income on an annual basis as provided in subsection (1);

"(D) the final tax shall be the tax as computed under subparagraph (A) plus the tax as computed in subparagraph (B) minus the tax as computed in subparagraph (C)."

If the above amendment is applied to a simple situation, its operative effect will be clearer. Assume an individual on a calendar year basis is a member of a partnership having a fiscal year ending January 31. He decides to change to a January 31 fiscal year. As a result he is required to file a return for the short period; namely, January 1 to January 31, 1959, and to annualize. Let us further assume that the individual has $1,000 of interest income and $15,000

of distributable income from the partnership for its fiscal year ending January 31, 1959, and that all deductions and exemptions are ignored except for the fact that the taxpayer as a married man is entitled to split his income.

If there were no annualization, the taxable income would be $16,000, and the tax payable would be $3,920.

Applying my suggested amendment, the tax would be computed as follows:

(*a*) Income, $1,000.
  Annualized, $12,000.
  Tax on $12,000, $2,720.
  Tax payable (one-twelfth) $226.67.

(*b*) Income, $16,000.
  Tax payable, $3,920.

(*c*) Income, $1,000.
  Tax payable, $200.

(*d*) Final tax, $226.67, plus $3,920, minus $200, or $3,946.67.

I respectfully urge that consideration be given to the problem I have described and that a provision along the lines above suggested be inserted in the amendments to the Internal Revenue Code to be proposed at this session of Congress.

I shall, of course, be pleased at any time to furnish additional information and discuss the matter with you or the staff of your committee.

Sincerely,

THEODORE TANNENWALD, Jr.

J. N. MEEKS & Co.,
Columbus, Ohio, March 24, 1960.

H.R. 9662. Trust and Partnership Income Tax Revision Act of 1960.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

MY DEAR MR. CHAIRMAN: The tax revenue that will be attributable to the multiple trust legislation proposed in section 669 of the Trust and Partnership Income Tax Revision Act should be carefully weighed against the discriminatory and harsh effects such legislation will have on accepted forms of property disposition. In protest to the enactment of section 669, I have several comments:

First, section 669 unduly penalizes the individual who is motivated to create more than one trust for the same beneficiary by reasons that are entirely apart from any tax economies. Certainly, a father who creates an inter vivos trust for his 2-year-old son cannot be expected to forsee the child's future behavior and needs. As the child matures and money values change, commonsense may, and probably will, dictate a modification of the trust terms, but if the father has created an irrevocable trust, what choice does he have other than to establish an additional and separate trust. Recognition must be afforded the indisputable fact that changing circumstances do necessitate leeway in multiple trust legislation. Clearly, the advisory group was cognizable of this when it exempted up to three inter vivos trusts, provided they were created at more than 5-year intervals.

Second, the administrative burdens and problems imposed on a fiduciary by the proposed legislation are out of proportion where the combined income of multiple trusts is so small in amount that no significant tax avoidance is possible. Again, the advisory group with their recommended $2,000 de minimis exception gave recognition to this.

Third, the joining of a grantor's inter vivos trust with his testamentary trust is unduly harsh. The vast majority of testators who create residuary trusts under their wills do so without thought of the tax consequences and effect such trusts will have because of inter vivos trusts. Family needs and investment management are the motivating factors behind testamentary trusts, not multiple trust income tax avoidance. Surely, it is not equitable to penalize the husband who leaves his residuary estate in trust for his wife, or other beneficiaries, primarily because she or they are not skilled in property management.

In conclusion, I firmly believe that the past conduct of certain taxpayers justifies the enactment of some form of multiple trust legislation. However, I strongly recommend that such legislation be directed toward the more flagrant

cases of tax avoidance, and that it not impose administrative and costly tax burdens on the individual who merely is engaged in sound financial planning through the use of long accepted vehicles for property disposition.

Very truly yours,

JACK N. MEEKS.

KIRKLAND & GODBOLD,
Birmingham, Ala., March 1, 1960.

U.S. Senate Committee on Finance, Washington, D.C.

GENTLEMEN: I wish to submit this statement to be incorporated in the records of the hearings on H.R. 9662.

It is my considered opinion that section 741 of the Internal Revenue Code should be amended to allow ordinary losses instead of capital losses where there is a loss from the sale of a partnership interest. I strongly feel that severe injustices have already resulted from the administration of this section and that such amendment should be made retroactive to its enactment.

For a long period of time prior to the passage of the 1954 income tax code, taxpayers were contending in the courts for capital gains on the sale of a partnership equity on the grounds that such an equity was a capital asset. The advantage to the taxpayer in treating the gain as a capital gain is obvious. The courts sided with the taxpayer in most cases and the concept of a partnership equity as a capital asset was written into the law in section 741 of the 1954 Code. We can find no cases where the question of a loss from a partnership sale has ever been litigated. However, under section 741 as it now stands, such losses would have to be capital losses.

I have a specific case in mind involving the sale of all partnership properties of a husband and wife partnership to a single purchaser who continued to operate the same business as a corporation. All of the partnership assets are listed separately in the contract of sale. In similar cases, the courts have always held such sales to be the sales of respective single partnership interests subject to the capital gain and loss provisions of the Internal Revenue Code. The partners in my case could have sold each partnership asset separately to different purchasers and achieved the same result with ordinary losses, deductible in full. Moreover, a sole proprietorship with the identical composition as this partnership could be sold in a lump sum sale at a loss which would be fully deductible as an ordinary business loss rather than as a capital loss with all of its unfavorable restrictions.

I want to make it clear at this point that, although these taxpayers were clients of my firm, the sale of this business was completed before we had any knowledge of the deal. We are therefore not asking for corrective legislation to cover up one of our "boners."

The husband-partner died the same year. Since he owned 75 percent of the business, his capital loss will be of no benefit, since it died with him. Moreover, the loss will not be available as a carryback to preceding years when the taxpayers were in a high bracket.

As you are no doubt aware, capital gains are allowed where gains occur on sales of depreciable property under section 1231, and ordinary losses are permitted where losses occur. This same treatment could be given to the sale of a partnership interest with little harm to the revenue. Losses from the sales of partnership interests are too rare and infrequent to cause any great reduction in revenue.

To permit section 741 to remain as it is, will undoubtedly create many cases of severe injustice to small taxpayers, most of whom are unaware of this vicious tax trap. Such injustices will cause bitterness on the part of individual taxpayers which usually results in unfavorable and unjust criticism of the Internal Revenue Service and other taxing authorities. The partnership entity is a favorite method of operation for small taxpayers who cannot be expected to be familiar with obscure provisions of the Revenue Act such as section 741.

I am not trying to argue for or against the treatment of gain on the sale of a partnership equity as a capital gain. The idea of classifying a partnership equity as a capital asset has a judicial origin which was later ratified by Congress in passing section 741. It has no justification whatsoever from the accounting viewpoint. If inflationary trends enable a more fortunate or more wealthy taxpayer to reap capital gains, then the less fortunate taxpayer should be protected from the bitter fruits of adversity resulting from capital losses when a lifetime

accumulation of wealth must be disposed of in the most convenient manner at a distress sale during a major emergency such as the one experienced by our client. This widow is now prohibited from carrying back an operating loss to preceding years when she paid relatively high tax rates. Her small share of the capital loss carryover is of little value to her.

I realize that there has been some criticism of section 1231 which allows capital gains where no capital assets are sold, with no offsetting penalty for losses.

I would like to point out, however, that sales of partnership interests are relatively rare and infrequent when compared with sales of depreciable property. The partnership is a favorite means of operation for the small businessman, who is generally unaware of the tax trap contained in section 741 restricting his losses to capital losses on sale of his interest. The typical partner is also generally unaware of any benefits accruing to him by reason of capital gains on sale of his interest. From my personal experience with partners and partnerships, I would be willing to say that about 98 percent of the sales or exchanges of partnership interests are made without giving any recognition whatsoever to section 741, and are never even scrutinized by the Internal Revenue Service. My colleagues in the accounting profession seem to be of the same opinion.

My reasons for recommending corrective legislation may be briefly summarized as follows:

(1) It is unjust to classify loss on the sale of a partnership equity as a capital loss with a limited deduction when the full amount of tax has been paid on the accumulation of the assets making up such equity. The net worth making up a partnership equity is no different from the net worth making up a sole proprietorship equity, loss from the sale of which is fully deductible.

(2) The partnership is usually a small business entity which cannot be expected to be thoroughly familiar with such technical tax traps as section 741, especially when an immediate distress sale is advisable, such as in the instant case.

(3) The relief given in section 1231 on the sale of business property could be extended to the sale of partnership entities to provide equitable relief for a limited number of small taxpayers. Wealthy taxpayers will always be able to find a way to bypass section 741 and get ordinary losses anyway, therefore, there would be no appreciable loss in revenue.

I sincerely hope that your committee will see fit to seriously consider the retroactive correction of the injustice which section 741 places on the small taxpayer who, in rare instances, is forced to dispose of a partnership interest at a sacrifice in a distress sale.

Yours very truly,

R. H. KIRKLAND,
Certified Public Accountant.

DRINKER, BIDDLE & REATH,
Philadelphia, March 1, 1960.

Re H.R. 9662 (trust and partnership income tax revision bill of 1960).

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D.C.

GENTLEMEN: Under the proposed new section 764 of the code, as enacted by the House of Representatives (H.R. 9662), the taxable year of a partnership will close with respect to a deceased partner as of the date of death of such partner, unless his successor in interest files an election not to close the taxable year as of such date. The result of this will be that the successor in interest will have the option of having the distributive share of partnership taxable income of the deceased partner for the partnership year in which he dies included in his final lifetime return, or of having such distributive share taxed to his successor in interest. Such successor in interest could, of course, be the widow of the decedent.

The result of this amendment will be that at least two alternative methods will be available to make the distributive share of a deceased partner taxable in the joint return of the decedent and his widow for the year of his death. However, by reason of the proposed amendment to section 691, substantially different tax results will flow from the two methods. This is because section 691, as amended by H.R. 9662, will make the distributive share of the decedent attributable to the period up to the date of his death "income with respect

to a decedent," with the result that the person taxed with such distributive share will receive a deduction for the estate tax attributable to such distributive share, even though all or most of such distributive share was withdrawn by the decedent partner during his lifetime. Thus, if the distributive share is taxable on the joint return by reason of the widow being the successor in interest and by reason of her electing not to have the partnership year close on the date of death, a substantial deduction can be available to the widow on the joint return. On the other hand, where such election is not made (through inadvertence or lack of planning), the same amount is included in their joint taxable income but no deduction is available.

For example, suppose that a partner in a calendar year partnership dies on December 15. His distributive share of partnership income for the year is $50,000, of which $45,000 is attributable to the period up to December 15. The decedent is in a 50-percent estate tax bracket. He is survived by a widow. Under the terms of the partnership agreement, his estate, or any successor in interest he may designate, is entitled to receive all of his capital interest in the partnership as well as any undistributed income. During his lifetime, the decedent partner withdrew $45,000 of distributable income.

If the election provided by the new section is not made, the partnership taxable year will end on December 15, and the decedent's last return will have included in it $45,000, which will be eligible for inclusion in a joint return with the surviving widow. On the other hand, if the election is made, and the widow has been designated successor in interest, the same $45,000 will be taxable to the widow on the same joint return. However, because taxability is by way of the widow it will constitute income in respect of a decedent, and she will be entitled to an income tax deduction of $22,500, which will be the estate tax attributable to such amount. This deduction would be available even though the distributive share, to the extent withdrawn prior to death, is not actually included in the gross estate.

If a deduction for estate tax attributable to the distributive share of the decedent is to be allowed as a deduction on the joint return in one case, should it not be also allowed in the other? Of course, those who file the election, and take the other necessary steps, can obtain the deduction, but it seems doubtful whether the availability of the deduction should depend upon this technicality when the same amount is being taxed on the same joint return.

Respectfully submitted.

ERNEST L. NAGY.

THE FIRST NATIONAL BANK OF COLORADO SPRINGS,
February 26, 1960.

In re H.R. 9662, "Trust and partnership income tax revision bill of 1960."

Hon. HARRY BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SIR: As the officer in charge of the income tax administration in the trust department of this bank, I will respectfully invite your attention to a change in the form of the bill as it came out of the House of Representatives from the way the bill was submitted last year. I feel that this change will complicate the administration of estates in process of administration and should not have been made, and the language of the bill as it came out last year should be restored.

In the 1959 bill, section 663(a)(2), referring to certain exclusions, provides in part as follows:

"(a) EXCLUSIONS * * * (2) OTHER GIFTS, BEQUESTS, ETC.—Any amount other than capital gains considered paid, credited, or required to be distributed under section 643(a)(3)(B), which under the terms of the governing instrument or applicable local law is an amount which is not to be paid or credited at intervals and which is properly paid or credited in full or partial satisfaction of a bequest, share, award, or allowance from the corpus of a decedent's estate during a period beginning with the day following the death of the decedent and ending 36 months thereafter. A payment shall be deemed to have been made from corpus of a decedent's estate to the extent it is properly charged against corpus and designated as a distribution of corpus on the books and records of the estate by the fiduciary."

The current or 1960 bill at section 108(a)(2), the counterpart of the paragraph just quoted from a 1959 bill provides as follows:

"OTHER GIFTS, BEQUESTS, ETC.—Any real property or tangible personal property (other than money) held by the decedent at the time of his death which is properly distributed, before the close of the 36th calendar month which begins after the date of the death of the decedent, in full or partial satisfaction of a bequest, share, award, or allowance from the corpus of a decedent's estate."

The effect of this modification of the 1959 bill is to continue to tax to a recipient of a partial distribution of corpus of an estate during administration the income of the estate for the year in which the distribution of corpus is made, even though such recipient of a corpus distribution does not receive the income in such year. This is in conflict with the recommendation of the carefully selected advisory group on subchapter J of the Internal Revenue Code of 1954, whose recommendation was incorporated in the 1959 bill and which recommendation the undersigned submits is sound and should be followed. It is submitted that a person who receives a distribution of stocks and bonds during the administration of an estate, which distribution of stocks and bonds is not accompanied by a distribution of income, should not be placed in a position whereby they may have to bear a heavy income-tax load and have no means of paying it other than a partial liquidation of the assets which they have received through such partial distribution. For example, if you were to receive a distribution in the first year of an estate's administration of $100,000 in stocks and bonds, this could conceivably, under the 1960 bill as presently under consideration, impose a heavy income-tax burden on you for the year in which the distribution of corpus is received. It is quite conceivable, and even probable, that the only way you would be able to pay the income tax liability on this corpus, if you did not receive any income along with it, would be to liquidate a part of the corpus to pay the income tax obligation.

It is respectfully requested that the Senate Finance Committee seriously consider going back to the 1959 bill and the original recommendation of the carefully selected advisory group. In this way, innocent beneficiaries of estates will not have thrust upon them by inexperienced executors unexpected and unusual tax burdens. It is even possible in many instances that, if the estate were to pay the income tax for the year in question, the Federal Government would receive more revenue than if the beneficiary were to pay the tax. I am unable to see that there is necessarily any loss of revenue to the Government in this situation. I recommend, therefore, that the exclusion be extended to include not only real property or tangible personal property, but any property paid out of corpus received during the first 36 months of the administration of a decedent's estate.

Respectfully submitted.

JAMES B. DAY, *Trust Officer.*

TURK, MARSH, OUCHTERLONEY & KELLY,
New York, N.Y., February 25, 1960.

Re section 669, H.R. 9662.

HON. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

MY DEAR SENATOR BYRD: I sincerely trust that your committee will substantially amend the provisions of section 669 of H.R. 9662, relating to multiple trusts.

There is no question that multiple trusts, in the true sense of the word, involve a potential means of tax avoidance which should be stopped. However, the evil rises in cases where property is splintered up into numerous trusts for the purpose of securing the benefit of low tax rates without any other justification. I respectfully submit that the prevention of an evil of that sort does not necessitate the administrative complications which will arise under section 669 in any case where the same grantor has created two trusts for the benefit of the same beneficiary and there has been an accumulation of income.

I believe that the application of section 669 to trusts involving only two trusts stems from the type of thinking that all taxpayers must be treated with absolute equality no matter how many complications that will inject into the staute or the administration thereof. If multiple trusts are treated as an avoidance problem, I believe they can be effectively stopped without injecting very many complexities into the administration of the law.

The mere fact that the same donor may have created three or four trusts for the benefit of the same beneficiary and that in the ordinary course of administration some of the income has been accumulated, does not show that tax avoidance was the motivating cause for the creation of the trust or even for the accumulation of the income. After a grantor ha created a trust for a beneficiary and has seen it in operation for a while, he often decides that he would like to put more property in trust for such beneficiary. As the grantor prospers, he may decide to make still further transfers. In that type of situation, changes in the family situation or the desire to make changes in the trustee's powers, usually results in the creation of a new trust rather than the mere addition of property to an existing trust. It has been my experience that under those conditions tax avoidance not only is not the motive for the creation of the separate trusts, but usually is not even considered. That is an entirely different situation from the case where an appreciated piece of property is transferred into numerous trusts prior to sale or 20 or 25 trusts are set up to accumulate income for the same beneficiary.

It seems clear to me that the statute should not affect the normal situation where three or four typical family trusts have been created for the same beneficiary over a period of time, but that it should be confined to what are really multiple trusts. Obviously taxpayers will not even attempt to set up such multiple trusts if the tax advantages have been taken away by statute. Under those conditions the mere existence of the statute will be a silent policeman barring the type of avoidance which should be stopped. On the other hand such a statute will not require a very complex statute to be administered merely because a small number of trusts have been created for the same beneficiary for perfectly sound reasons having nothing to do with taxes.

Very truly yours,

CARTER T. LOUTHAN.

(Whereupon, at 12:30 p.m., the hearing was recessed, to reconvene at 10 a.m., Thursday, April 21 1960.)

TRUST AND PARTNERSHIP INCOME TAX REVISION ACT OF 1960

THURSDAY, APRIL 21, 1960

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10:15 a.m., in room 2221, New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd, Long, and Williams.

Also present: Elizabeth B. Springer, chief clerk; and Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order.

The first witness is Mr. Laurens Williams, of Sutherland, Asbill & Brennan, Washington, D.C.

Proceed, sir.

STATEMENT OF LAURENS WILLIAMS, SUTHERLAND, ASBILL & BRENNAN, WASHINGTON, D.C.

Mr. WILLIAMS. Mr. Chairman, my name is Laurens Williams. I appear at Mr. Stam's request, as a member of the Advisory Group on Subchapter J of the Internal Revenue Code of 1954 to the Subcommittee on Internal Revenue Taxation of the Committee on Ways and Means.

On behalf of all of the members of that advisory group, I want to make it clear at the outset that it is our unanimous view that, on balance, the provisions of H.R. 9662 which deal with the taxation of income of estates, trusts, beneficiaries, and decedents would represent a real and important improvement over present law. While I would suppose that no one would think the bill perfect, we believe that it would eliminate many inequities and hardships created by present law. While there doubtless will be many objections to particular parts of the bill—and I shall make several in the hope of contributing to improvement of the measure—I want to make it completely clear that, on balance, I consider the bill important, and hope that it will be promptly enacted.

A majority of the recommendations which were made by the Advisory Group on Subchapter J have been incorporated in the bill, many verbatim. There are, of course, some differences, as was to be expected. Most of the bill's departures from the recommendations of the advisory group involve either points of very minor importance or points on which the bill has adopted some alternative solution to a particular problem which the members of the advisory group consider acceptable.

Incidentally, the advisory group made no recommendations with respect to the supposed terminable legal interests problem dealt with in section 101 of the bill.

Inevitably some technical problems have arisen from the redrafting and revision of the advisory group's draft statutes. These have been or will be called to the attention of your professional staff, for whose competence and ability wisely to solve these technical problems the advisory group has the highest regard and esteem, hence I will not impose on the committee's time with technical "flyspecking" on these minor points.

There are, however, several major matters on which there is a marked and very important difference between the advisory group's recommendations and the provisions of H.R. 9662. With your permission, I will direct my comments to two of these major points.

First is the matter of multiple trusts. This is one of the major provisions of the bill, in my view. It was designed to close a loophole which has been in the law since 1913. You considered the problem, at the instance of the Treasury Department, some 20 years ago. In fact, as I recall, it was during the hearings on the Revenue Act of 1937. Congress at that time apparently thought it would solve the multiple-trust problem simply by lowering the exemption of a trust to $100 vis-a-vis the $600 exemption given all other noncorporate taxpayers. I personally think it clear that your action of 20-plus years ago in lowering the exemption of a trust to $100 has not completely solved the problem at all.

The bill now before you undertakes to plug the multiple-trust loophole by providing that, when accumulated income of a trust which is distributed to a beneficiary who already has previously received one or more distributions of accumulated income of other trusts created by the same grantor, the beneficiary is to be taxed on that income in an amount equal to the tax he would have had to pay if he had received this income directly from the trust at the time it was earned by the trust, to the extent it was earned during the preceding 10 years, and, of course, he would receive a tax credit for the amount of taxes paid on the income by the trust.

I believe this approach to a solution of the problem is inherently defective and that it will not stop the use of multiple trusts for tax-avoidance purposes.

Let me first put an example to illustrate (1) how multiple trusts currently can be used to save income taxes, and (2) how the bill as now drafted and as now before you undertakes to meet that problem. This example also will serve to show why, in my opinion, the proposed solution to the multiple-trust problem in H.R. 9662 just will not do a complete job.

Suppose that F (F for father), a man of large wealth—and, incidentally, multiple trusts can be used to obtain substantial tax benefit primarily where large sums of money are involved—wishes to set up a substantial accumulation trust for his son, S, who already has some independent income. Assume that F wants to put $1 million into the trust, and that, on the average, the $1 million in trust will produce $50,100 ordinary net income per year.

If F creates a single trust, that trust will pay $26,820 income tax on its $50,100 before tax net income. The trust will have reached a

75-percent tax bracket. After income taxes, it will have only $23,280 left out of its $50,100 income to accumulate annually.

Under present law, use of multiple trusts will save a big part of that $26,820 annual income tax bill. If, instead of 1 trust, F puts the $1 million into 100 separate trusts, each of the separate trusts will have only one one-hundredth of the $50,100 income per year ($501), will have its separate $100 exemption, will be only in the 20-percent tax bracket, and thus will pay only $80.20 annual income tax. Thus the total annual tax bill of the 100 trusts will be only $8,020 vis-a-vis the $26,820 tax bill of a single trust.

Thus, by use of 100 trusts instead of a single trust, F will have saved $18,800 per year in taxes for the trusts, all of which ultimately will go to S, his son. The amounts accumulated by the 100 trusts will be $42,080 per year on earnings on the original $1 million alone, instead of a net accumulation of only $23,280 per year which a single trust could accumulate after taxes.

If the 100 trusts continue for 20 years, there will be $376,000 more in the trusts for S, the son, than there would be if a single trust had been used. Please note that this computation—in arriving at that figure of $376,000, I have not taken into account the additional earnings and accumulations during the 20 years which will flow from investments of the additional $18,800 per year which will be accumulated in the multiple trusts as a result of the tax savings they effect.

The bill attemps to meet the multiple-trust problem by providing that when the trusts terminate and the accumulated income is distributed to a beneficiary, there will then be imposed—at time of distribution—a tax on the beneficiary, which is equal to the tax the beneficiary would have had to pay on the income if—to the extent of the income accumulations during the last 10 years of the trust—the trust income had been distributed to him currently from year to year instead of being accumulated and, of course, as I stated before, he would be given a tax credit against this tax for the amount of taxes paid on the accumulated income paid of the trusts during the time they were paying the tax on the income.

Now, in general, this sounds pretty good. Under this proposed solution, the accumulated trust income ultimately is going to be subjected to tax at whatever tax rates would have been applicable to the beneficiary if the income had actually been distributed to him (with a limitation of 10 years). Moreover, under this approach under the bill the tax would always be imposed on what you might consider the proper person—that is, on the beneficiary who actually gets the income which has been accumulated. Of course, there are some technical problems in this approach, to which I do not find any answer in the bill or in the Ways and Means Committee report.

For example, suppose that in the illustration I gave, the originally intended beneficiary, S, happened to die at the end of 18 years, and that under the terms of the trust instruments all accumulated income was paid over to S's son (the grantor's grandson). Now, suppose this lad was just 1 year old at the time. Just how, under this bill, you are going to throw back the accumulated trust income of the last 10 years, and tax this 1-year-old child on income accumulated during the 9 years before he was born is not clear. Would a theoretical amount of net taxable income be attributed to this nonexistent tax-

payer in years prior to his birth? Would he be given a $600 annual personal exemption in years prior to his birth? Presumably, he couldn't itemize his deductions, so would you allow him the optional standard deduction?

Suppose the distributee of the accumulation trust is not an individual, but is another trust—a new trust just come into existence. How would it be handled? I do not think it is at all clear, under the bill, whether or how the 10-year throwback would operate in such a case.

These are relatively minor questions, for which the professional staffs doubtless can provide acceptable solutions. There are other problems of a semitechnical nature and relatively unimportant. I want to mention one of these.

In taxing the beneficiary on this accumulated income, what are known as the character rules would not apply. Thus, tax-exempt income would be fully taxed. The beneficiary would be deprived of special credits and exclusions. The result: heavier taxes than if the income had been currently distributed.

Moreover, the bill would work haphazardly, producing bizarre results in given instances. This is because under the bill only distributions of accumulated income from what are called multiple trusts are taxed to the distributee-beneficiary, and in deciding when a trust is a multiple trust the first trust to make an accumulated income distribution to a beneficiary is not considered a multiple trust; it is considered the primary trust and accumulated income distributed by the so-called primary trust is not taxed to the beneficiary. That is to say, only distributions of accumulated income from so-called multiple trusts are taxed to a beneficiary. The first accumulation trust to make a distribution to a particular beneficiary is considered the primary trust and is not taxed. Thus, if the primary trust has large accumulations, they go out to the beneficiary scot free, whereas if the large trust happens to be the second one or the third and fourth to make a distribution, it is a multiple trust and its distributions would be taxed. But this, too, in my opinion is not the central problem.

In my judgement, the real question is whether this legislation will plug the loophole, so to speak—whether it will prevent tax avoidance by use of multiple trusts. It is my opinion that, unfortunately, the bill does not provide a complete solution to the multiple-trust problem. It does go part way. I want to make that perfectly clear. It *would* ultimately subject much accumulated trust income to tax in the hands of the beneficiary who ultimately receives it. But—and this is its weakness—I think it will actually *guarantee* a highly attractive method of obtaining tax deferment—it assures a sort of surtax-free buildup through use of multiple trusts. In a sense it tells the sophisticated tax advisers, and the high surtax bracket taxpayers of the country who are looking for tax-avoidance or tax-minimization devices, that multiple trusts offer them a way to defer, indefinitely, the time when the "bite" of the progressive tax rate will be applicable to trust income. Instead of outlawing the use of multiple trusts, I think it has the effect of *sanctioning* their use for tax-deferral purposes.

Frankly, I think it means that you are imposing upon lawyers and tax advisers generally the duty of pointing out to their clients that

by the simple device using multiple trusts they can be assured that the maximum current year-by-year income tax on accumulated income will not exceed 20 percent, and that the trusts thus can have the use of the cash conserved by the multiple-trust device for as many years as the trust continues.

I think that in some situations this might mean that the use of multiple trusts would still be an attractive avoidance device especially in quite long-term trusts, which would extend beyond, well beyond, the period reached by the 10-year throwback.

Now, to return to the example I gave earlier, of the father who wants to put a million dollars in trust for his son, S. Under the bill before you, just as under present law if F puts a million dollars into one trust, the trust would pay $26,820 on its accumulated income and be able to accumulate only $23,280. At the end of 20 years, the accumulations would total $465,600 *plus* the earnings of the accumulations themselves. But the earnings of the accumulations of that single trust all would have been subjected to tax at 75 percent or more from year to year, as earned.

If, on the other hand, under the provisions of the bill before you, F puts this $1 million into 100 separate multiple trusts, the 100 separate trusts would cumulatively pay only $8,020 annual current income tax, and they would continue to be able to accumulate $42,080 per year, exactly as is true under current law. At the end of 20 years the total net after-tax accumulations in the 100 trusts of earnings on the original $1 million would total $841,600—almost twice as much as a single trust could accumulate—*plus* the earnings of the accumulations themselves. Moreover—and this is a vital point—they would have been able to accumulate the earnings of these larger accumulations subject to current tax at only 20 percent instead of the 75 percent a single trust would have to pay.

It is perfectly true that, if multiple trusts are used, these additional, larger accumulations—to the extent accumulated during the last 10 years—will be subjected to further tax when ultimately distributed. Nonetheless, until that time arrives there will have been a most attractive partially tax-free buildup.

To roughly analogize; do not press the analogy too far, but to analogize, it seems to me that the approach taken in the bill is somewhat like your saying to me: "Mr. Williams, we're going to let you postpone, *without interest*, the current tax on your income above 20 percent. For the next 5 or 10 or 20 or 30 years, whatever period you want to select, when you file your annual tax return, just compute your tax by applying a flat 20-percent rate to your taxable income. Then—in some future year—5 or 10 or 20 or 30 years from now—you are to pay, *without interest*, an amount equal to the difference between the 20 percent you've paid from year to year and the amounts of tax you should have paid under the rates that applied from time to time, under section 1 of the Internal Revenue Code, during the period when we allowed you to defer payment of part of your tax."

Well, I'd like it if you made that offer. So would everyone else you allowed to defer the time when he had to pay. I would be delighted with such a system and I suspect everyone else would, because the advantages of deferring the time of payment of tax are very important, of course.

And that difficulty is inherent in the approach taken to a solution of the multiple-trust problem by the bill. The bill clearly, in my judgment, sanctions the splitting of accumulation trust income through the use of multiple trusts—throughout the entire period of accumulation—and clearly defers the time of payment of the full tax. In my opinion as long as you defer—postpone—the application of the progressive rate schedule to income being accumulated for a particular beneficiary, you will not have fully plugged the present multiple-trust loophole.

There is another objection to the approach in the bill. The multiple-trust problem is itself solely and only a problem of splitting income into many separate returns for the purpose of avoiding high tax brackets. It is *not* a matter of splitting income between a beneficiary and a trust; it is a matter of splitting trust income among many separate trusts.

The approach of the bill confuses these two situations, and proposes a solution which might be appropriate if you are going to adopt an entirely new principle of income taxation and say that whenever income which has been accumulated in a trust is paid out to a beneficiary it shall be taxable in the hands of the beneficiary, but, so far as I am aware—and I think I would be aware of it were it so since, frankly, I think I started this whole multiple-trust legislation in 1955 when I was in the Treasury—no one has intended that such a new principle of tax law be adopted.

Thus, to be blunt about it, I think the whole approach in the bill conceptually wrong. The solution of the multiple-trust problem ought to be directed at the multiple-trust problem—the splitting of *trust income* being accumulated for the same beneficiary—not at an entirely different problem. The bill does absolutely nothing about the splitting of trust income.

Instead, it sanctions such splitting but, at a later date, imposes an additional tax, not on the multiple trusts but on another taxpayer who may or who may not be the beneficiary originally intended to receive the accumulated income, which tax may or may not be large enough in amount to vitally impair the tax-saving value of the multiple-trust "gimmick."

The Advisory Group on Subchapter J recommended a different approach. Under its approach, with very reasonable exceptions, all income of all trusts created by the same grantor which was being accumulated for a single beneficiary would be consolidated and would be taxed *currently*. There thus would be no deferment of the time of tax, and no partial tax-free buildup in the trust. There would thus be no income splitting at all, and no deferment of the time of tax. This would strike directly at the root of the problem and take away the current advantage of using multiple trusts in lieu of a single trust, since all trust income being accumulated for the same beneficiary would be taxed currently as if it all were the income of a single trust—in complete symmetry with the rest of the tax law in this area.

The advisory group's recommendation was not perfect. I suppose that everyone who has worked exhaustively on this subject would agree with one conclusion reached by the advisory group; that is, there is no completely perfect solution to the problem. The approach taken in the advisory group's recommendation admittedly involved

one very difficult problem: that of determining when the income of several trusts established by the same grantor is being accumulated for the same beneficiary.

All of us who were members of the advisory group recognized that there might be ways in which, in limited instances, and ingenious, adroit, drafstman, finding the right set of circumstances, might be able to partially avoid the impact of the solution to the problem we recommended. However, such a draftsman would be skating on thin ice, with little or no certainty that he would succeed in his tax-avoidance purposes. I can only say that, in the unanimous judgment of those of us who served on that advisory group, the approach we recommended was sounder and wiser than that embodied in this bill.

If the committee believes that the exceptions recommended by the advisory group—permitting three or fewer trusts where no two were created within 5 years of each other; treating testamentary trusts separately from inter vivos trusts—are too lenient, this is mere detail which readily can be changed. Experience in the operation of the statute quickly could highlight any other defects, which you hereafter could quickly remedy.

So much for multiple trusts.

There is one other important difference between the bill before you and the recommendations of the advisory group on which I want to briefly comment, notwithstanding that I am confident other witnesses also will discuss it.

I refer to section 108 of the bill which, in accordance with the recommendations of the advisory group, extends to estates what is known as the separate-share rule which presently is applicable to trusts; and which section of the bill also adopts *in part only* an alternative recommendation made by the advisory group concerning the determination of which distributees of an estate have to pay income tax on the income of the estate. My concern arises out of the fact that the bill only partially adopts the advisory group's alternative recommendation dealing with the latter question.

My belief is that, while partial adoption of this alternative recommendation is quite helpful, it does not go far enough and under it there are still going to be many situations in which distributees of estates who have not received any distribution of income of the estate whatsoever are going to have to pay income tax on estate income even though they did not get any income. And I think that there are going to be other situations under the bill where others who have received income distributions from the estates are going to pay tax on far less than the amount of the income they actually have received, or on far more than they actually have received.

The problem arises out of the fact that the 1954 code created precise, specific, and quite arbitrary, absolute rules, which determine with finality who has to pay tax on the income of an estate. Experience has shown that these hard-and-fast rules are very arbitrary and sometimes are most inequitable. In some instances an heir or legatee who receives absolutely nothing from the estate but corpus—principal—and who has absolutely no right at all to receive any income of the estate is treated for Federal tax purposes as having received some of the income of the estate even though in fact and in law he has not received any income.

Moreover, since present law results in treating some corpus distributions as though they were income distributions, current law operates to arbitrarily reduce some legatees' income taxes and wrongfully increase the taxes of other legatees.

I best can illustrate this by a quotation from the final report of the advisory committee:

Assume that a testator makes minor specific bequests to friends and divides the residue between his wife and a trust to be established for his minor son. He provides that all estate taxes are to be apportioned to the share of the residue in trust for the son. During the first year of administration the estate income was $20,000, none of which was distributed. The following distributions were made:

Specific bequest to A	$1,000
Specific bequest to B	1,000
Family car transferred to widow; charged to her share of residuary estate	800
Cash advanced to widow; charged to her share of residuary estate	200

During the second year of administration the net income of the estate (all ordinary income) was $20,000, all of which was distributed, one-half to the trust for the son and one-half to the widow. In that year estate taxes of $50,000 were paid, and a distribution of $15,000 was made to the son's trust from corpus and from the income accumulated in the preceding year. In addition, a payment of $64,000 out of corpus and income accumulated in the preceding year was made to the widow to equalize the aggregate of distributions made to her and to the son's trust during the estate administration. In making this equalizing distribution to the widow, the estate taxes were treated as having been paid on behalf of the portion of the residuary estate to which the son's trust became entitled. The corpus distributions to the widow in the prior year, including the automobile which was turned over to her, were also taken into account for this purpose.

Since section 663(a) in its present form does not exclude from the operation of sections 661(a) and 662(a) distributions from the residuary estate, the attribution rules of section 662(a) must be applied in determining income to be reported by the widow and by the son's trust for both years. Although the executor made no distribution of income in the first year of administration, under present law $1,000 of income will be attributed to the widow for that year on account of the distributions of the family car and of the cash advances out of corpus to her totaling $1,000. While these amounts were not required income distributions under sections 661(a)(1) and 662(a)(1), they constitute "other amounts" under sections 661(a)(2) and 662(a)(2) and, since the distributable net income for the taxable year exceeds $1,000, the widow is taxed on the full amount of the corpus distributions to her in that year.

In the second year the income of the widow under present law will also be subject to distortion. The distribution of $64,000 of corpus and accumulated income of the prior year to the widow in addition to one-half of the current year's income ($10,000) would result in the widow being taxed with

$$\frac{\$74{,}000 \text{ (total distributions to widow)}}{\$99{,}000 \text{ (total distributions made to all beneficiaries)}} \times \$20{,}000$$

or approximately $14,950, while the son's trust would be taxed with only $5,050

$$\text{which is } \frac{\$25{,}000}{\$99{,}000} \times \$20{,}000$$

although each received $10,000, one-half of the distributable net income of the estate for the taxable year. The effect of the attribution rules of present law, therefore, is not only to defeat the attempt of the executor to divide estate income evenly between the beneficiaries, but to attribute arbitrary amounts of income to the beneficiaries. The son's trust is taxed with much less income than was actually received and the widow is really taxed on corpus she received.

In my opinion, this was probably the worst defect in the 1954 Code provisions dealing with income of estates and trusts. The 1954 Code does exclude bequests of specific sums of money and bequests of specific property from the category of estate distributions which are treated by the code as being distributions carrying taxable

estate income to the distributee, where the distributions in satisfaction of a specific bequest of money or of specific property are paid or credited all at once or in not more than three installments. But, as noted, there are a very large number and numerous kinds of estate distributions which are purely and solely distributions of corpus which cannot come within this exclusion in the law at the present time.

Now, the advisory group recommended that this situation be remedied by creating an additional exclusion for amounts properly paid or credited from the corpus of a decedent's estate during the 3 years after the decedent's death. The advisory group recognized that there might be objection to that recommendation on the ground that it allowed executors too much leeway, enabling them to so maneuver in the handling of distributions of corpus and income as to unfairly minimize the overall income taxes paid by the estate and the distributees. Accordingly, it submitted an alternative proposal—the one which the present bill has adopted *in part*.

The alternative proposal is that any distribution *in kind* which an estate makes of *property which the decedent owned at the time of his death* (other than cash) be excluded from the operation of the general rule that all estate distributions are deemed to be distributions of income of the estate (to the extent of the estate's distributable net income). This would parallel the present code exception from the operation of the general rule of distributions in payment of bequests of specific sums of money and distributions in satisfaction of bequests of specific property.

The bill adopts this alternative recommendation only in part. The difficulty is that it specifically excepts only distributions of real estate and of *tangible* personal property owned by the decedent at the time of his death. Thus distributions of *intangible* property—stocks, bonds, and so forth—which the decedent owned at the time of his death would still be treated under the tax law as distributions of taxable income of the estate, to the extent of the estate's taxable income. It is perfectly true that adoption of the so-called separate-share rule will solve the problem in many instances, so that there will not be so many instances of unjust results. But it is likewise true, in my opinion, that there will be many situations in which the separate-share rule will not, of itself, eliminate the harsh and inequitable result that currently pertains under current law, and which will remain unsolved by the bill in its present form.

Subchapter J, I think, is clearly one of the most complex and least understood subchapters in our Internal Revenue Code. Its intricacies and complexities may not be beyond the understanding of the average lawyer who probates decedents' estates, but in actual fact its intricacies are certainly not familiar to or understood by the average lawyer and the average administrator or executor. Certainly, the average person would never dream that when the administrator of an estate distributed to the heirs of the estate, in a partial distribution, stocks and bonds which the decedent had owned during his lifetime, the administrator was thereby making a distribution of income (entirely separate money) which the estate had received after the decedent's death. The whole concept is utterly foreign to the concepts of State law which govern descent and distribution of property of a

deceased person. The average lawyer probating an estate would never suspect that there even existed such a strange concept, so utterly out of joint with State law. Yet, because of the provision I am talking about in the bill, this bill does not cover stocks and bonds and other intangibles owned by the decedent during his lifetime, and the distribution of those items, which clearly are corpus, would still be treated under the bill as carrying income of the estate out to the distributees. I do not know of a more offensive trap for the average general practicing lawyer than this one.

Now, it was the opinion of the advisory group that the potential for tax maneuvering by sophisticated executors of a large estate who are being advised by skilled, knowledgeable tax counsel is not great enough to justify the hardships and inequities and erroneous results that we think in some situations will still follow if you exclude from the exclusion, in section 108 of the bill, intangible personal property owned by the decedent at the time of his death except, of course, cash.

That, gentlemen, completes my statement.

The CHAIRMAN. Thank you very much, Mr. Williams. Did I understand you to say that this bill is more complicated than existing law?

Mr. WILLIAMS. No, sir. I said that the present law, present subchapter J dealing with the tax treatment of income of estates and trusts, is, in my judgment, the most complex subchapter in the whole Internal Revenue Code. I think it is even more complicated than some of our corporate-distribution provisions.

The CHAIRMAN. You do not recommend outlawing of the multiple trusts?

Mr. WILLIAMS. I do not recommend——

The CHAIRMAN. You have a plan of permitting three or fewer trusts, and where no two were created within 5 years of each other; is that your suggestion?

Mr. WILLIAMS. No; that is not my objection, Mr. Chairman. My basic objection to the bill——

The CHAIRMAN. You say the committee believes, with the exceptions recommended by the advisory group permitting three or fewer trusts where no two were created within 5 years of each other. You offer that as a substitute, so to speak, for the multiple-trust part of the bill?

Mr. WILLIAMS. I think, if the committee would adopt the advisory group recommendations, you would substantially solve the multiple-trust problem.

Now, if you feel, as has been suggested to the committee by Treasury, I understand, that the advisory group's recommendation was too lenient because it would still permit the use of multiple trusts because it would permit a grantor to set up as many as three multiple trusts, if he set them up 5 years apart. The reason for that part of our recommendation was that under the law today if the grantor is not to be taxable on the income of a trust he creates, he has got to have no right to amend or change or alter or revoke the trust. Therefore, if a man sets up a trust for his son today, he cannot reserve to himself the power to change provisions of that trust later on without personally continuing to be taxable on the income of the trust.

He may set up a trust today and, as the years go by, he may want to add to that trust or set up another trust for his son. Normally, he

might want to add to the old trust, but there may have been a change in circumstances so that some of the trust provisions, perhaps the person who is designated as trustee, are no longer acceptable to him. So, he sets up a separate trust, not for tax-avoidance purposes but because he cannot change the terms of the old trust. He has no power to do so.

So, all I am saying is that the considerations which lead many people to set up more than one trust are not tax considerations at all. They are not trying to minimize taxes. They are setting up separate trusts for practical business, personal reasons.

We thought that ought to be taken into account. We thought it was not unreasonable to say that a man could set up as many as three trusts without consolidating their income into a single tax return, if he sets them up over a reasonable period of time, so that it is not open opportunity for tax avoidance.

Now, all I am saying in this statement is this, Mr. Chairman: If you feel that that is too lenient, that it would still allow too much tax minimization through setting up three trusts 5 years apart, then you easily can cut it back to two, or you can cut it back to one if you want to. All I am saying, personally, is that I would much rather see the committee adopt the approach taken in the advisory group's recommendations than the approach taken in the bill, because of the tax-free buildup I think you would get under the bill.

The CHAIRMAN. You do not recommend outlawing multiple trusts? I gathered from your testimony here that you thought that was quite a tax loophole involved in multiple trusts.

Mr. WILLIAMS. The latter is correct.

The CHAIRMAN. Now, you just said you do not think they were established for that purpose, necessarily. It is very clear that it does give an advantage because you get in a lower income tax bracket by reason of having a number of trusts rather than having one trust.

Mr. WILLIAMS. Of course, any time income is being accumulated in more than one trust for the same beneficiary, there is going to be a tax saving; there is no question about it, because you are splitting.

Now, my major point is——

The CHAIRMAN. What I am trying to get at is what is your alternative? You do not want to outlaw it.

Mr. WILLIAMS. The alternative is——

The CHAIRMAN. Answer that question. You do not want to outlaw alternative trusts?

Mr. WILLIAMS. We do want to.

The CHAIRMAN. What is this suggestion that I understood you agreed with?

Mr. WILLIAMS. The recommendation of the advisory group was this: We unanimously felt that there was a possibility of tax avoidance through the use of multiple trusts. Some of the members of the group did not think it was serious, but we unanimously know that there is a possibility of tax avoidance with the use of multiple trusts which ought perhaps to be closed; the loophole ought to be closed.

Our suggested solution was this: We said any time the grantor sets up more than one trust to accumulate income for the same beneficiary, unless those trusts are set up, not more than three of them and each of those three at least 5 years apart, you are to consolidate the income of the multiple trusts.

In other words, in my illustration, if a fellow set up a hundred trusts, you would not allow them to report their income separately on separate returns; you would not let him split the income. You would make them report it, so to speak, all in one return and pay the same tax on all that income that would have to be paid if put in one trust, and you would tax it today and not 20 years from now.

Senator WILLIAMS. Would you tax it as an accumulated trust rather than as a distribution?

Mr. WILLIAMS. Yes. Now, that involves a problem, as I pointed out. It involves the problem of how to determine whether a trust is accumulating income for a particular beneficiary. How can you be sure that, if the trust which is not going to terminate in 20 years were going to be terminated today, the income from separate trusts would go to the same beneficiary?

We recognize it is a problem, and we recognize it does not have complete certainty of application. The bill does have that. But we still say the recommendations of the advisory group come closer to sloving the problem, plugging the loophole, so to speak, than the recommendations of the bill itself.

The CHAIRMAN. Thank you very much, Mr. Williams, for your statement.

The next witness is Mr. John B. Huffaker. Mr. Huffaker, take a seat, sir, and we are glad to see you before the committee again.

STATEMENT OF JOHN B. HUFFAKER, DUANE, MORRIS & HECKSCHER, PHILADELPHIA, PA.

Mr. HUFFAKER. Thank you, Mr. Chairman. With your permission, sir, I would like to submit my full statement for the record, but to abbreviate it for oral presentation in order to save the time of the committee.

The CHAIRMAN. Without objection, that will be done.

Mr. HUFFAKER. My name is John B. Huffaker, of the Land Title Building, of Philadelphia. I am appearing on behalf of a number of trusts that will be adversely affected by one provision in the proposed legislation.

These trusts provide that the income is to be paid to charity and, either during the term of the trust or on termination, payments from corpus are to be made to individuals.

H.R. 9662 proposes a radically different treatment for trusts of these types. I understand that a number of witnesses will oppose the new method of taxing the individual beneficiaries of these trusts, but if the committee decides to amend H.R. 9662 to continue present law as it applies to trusts of this sort or to follow the recommendation of the bar association as reflected in section 31 of H.R. 1059—that is, to treat charities basically as any other trust distributee—there is no need to give special consideration to the amendment I am proposing.

However, if the committee decides that the rules in H.R. 9662 are desirable, I respectfully request that the bill be amended so that the extremely harsh results from the application to trusts established before the bill was introduced in the House will be avoided.

I feel there are two compelling reasons why this amendment should be accepted even if the new method of taxing trusts that pay the income to charity is adopted for new trusts.

In the first place, the new method is apparently intended to impose a prohibitory tax penalty on the beneficiaries of certain types of trusts. This would represent a new congressional policy, and the bill would change the law applicable to existing trusts so that in some cases extremely inequitable results will follow.

I have some examples of application to existing trusts later in my statement.

I do not think a person should be penalized for having been charitably inclined.

Secondly, if this bill is enacted in its present form, persons who made gifts in trust to charity will not get the tax benefits from the gift that were provided by the law in effect at the time of the gift.

If the benefits offered to the donor for making the gift are withdrawn after the gift is made in this one instance, it is obvious that donors will be reluctant to make future gifts that are not economically possible without the benefits our tax law extends.

Under present law, in the case of a trust which requires the current income to be paid to charity, and an amount of corpus to be paid to an individual, either during the course of the trust existence or on termination, the corpus distribution is generally tax free since all the income has gone to charity already, and so there is no income that can be attributed to the recipient of the corpus.

The House committee report states that:

> Where a trust makes distributions to both charitable and noncharitable beneficiaries to the extent they do not exceed distributable net income, distributions to tax-exempt charities should not be allowed to eliminate or reduce the taxable income of the noncharitable beneficiaries.

Therefore, the House bill provides that:

> Noncharitable beneficiaries must include in their income all amounts distributed, to the extent of distributable net income of the trust or estate, unreduced by any distributions to charity. Thus, if a trust instrument provides that all of its income is to be currently distributed to a charity, and an equal amount of corpus is to be paid to an individual beneficiary, the individual beneficiary would be taxed on the entire distribution up to the extent of the distributable net income.

To fully realize the significance of this change, I think we must review the existing tax rules that relate to trusts that pay the income to charity and which the rules of the bill do not purport to change.

In the first place, the grantor gets a charitable-contribution deduction for the value of the gift to charity when he creates the trust, except when the corpus will revert to him. Under an amendment made in 1954 Code, a person does not get any charitable-contribution deduction if he creates a trust that has the income payable to charity and then the corpus is to revert to himself.

A second rule applicable to these trusts is that the grantor will not be regarded as receiving the trust income even if the corpus reverts to him after a 2-year period.

This was a particular device placed in the code to encourage persons who were running over their 20- or 30-percent limitation to create trusts for the benefit of schools, churches, hospitals, and then the

trust income would not be included in their income if the trust was for at least 2 years' duration.

Of course, the general rule for Clifford-type trusts is that the corpus cannot revert in 10 years. The third important rule applicable to trusts that pay the income to charity is that gifts and bequests are excluded from gross income except to the extent that the gift is of an income from property. That is, a gift to an individual is normally free from income tax although the property is to be held in trust to pay the income to charity for a period of years.

The House committee report points out that there are tax-avoidance possibilities in gifts in trust to charity. Of course, Congress has provided that every gift to charity is made more attractive by the tax inducements offered. In the case of an outright gift by a person in the 80-percent income tax bracket, a $1,000 gift to charity, that is deductible, would reduce his income tax by $800, so the $1,000 gift would only reduce his after-tax income by $200.

Thus, it is not really unique to gifts in trust to charity to say that there is a tax avoidance through these gifts; there is a certain amount of tax avoidance because Congress has sought to induce the taxpayers to support charities.

Now, I do not believe that the tax benefits cause people to make gifts that they would not make at all in the absence of the deduction and the tax benefits offered the grantor.

However, these tax benefits make it possible for the donors to be so generous, and make it possible for the charities to raise the amount of money—our schools, churches, and so forth—that is needed to support their efforts.

It is my belief that the enactment of H.R. 9662 in its present form would do much to nullify the inducements in our present law to make charitable gifts, and I want to call to the committee's attention four fairly typical examples of trusts created prior to 1960, just to show you how this bill would operate on existing trusts.

These are all actual trusts, with the facts somewhat simplified for the purpose of illustration.

Mr. A is in the 80-percent bracket. On December 1, 1958, he created a trust to pay the income to Y University for 2 years, and then for the corpus to revert to him. The trust has dividend income of $10,000 in each year and files its return on a calendar-year basis. On December 1, 1960, the corpus will revert to him.

Mr. A created this trust after being advised by his attorney that the income of the trust would not be taxed to him. This was important in his personal situation, since his other gifts to charity are so large that he could not give $10,000 additional per year and remain within the maximum limit on charitable contributions.

Therefore, he established a trust to take advantage of the express provision in the code that income of a trust for 2 or more years would not be taxed to the grantor if the income was paid to charities in certain classifications. Under H.R. 9662, if the corpus reverts to Mr. A on December 1, 1960, he will be taxed on all the trust income for 1960. That is, when he gets the same securities back from the trust that he originally placed in the trust, he would be deemed to have received the dividend income that the trust got during 1960 and paid over to the university under the terms of the instrument.

Mr. A thought this trust would deprive him of only 20,000 pretax dollars or 4,000 after-tax dollars since he is in the 80-percent bracket. Instead, he finds it can cost him 60,000 pretax dollars; the $20,000 that actually went to charity, plus the $40,000 of income that will be necessary to pay the tax due on termination of the trust.

In other words, the trust, instead of costing him 4,000 after-tax dollars, will now cost him, according to my computations, $12,000.

As a second example, Mrs. B was approached in 1959 by the local YWCA for a substantial gift. It was pointed out to her that, if she made a gift in trust with the income to be paid to the YWCA for 3 years and then for the corpus to be paid to her children, the income tax deduction on the creation of the trust would more than offset the gift tax she would pay on the gift to her children. Since she was anxious to be liberal with both her children and the Y, she created this trust in 1959.

If H.R. 9662 is enacted in its present form, her children will be taxed on the income of the trust in the year in which it terminates. Her children are grown and in substantial tax brackets themselves, so that the children will have a very substantial tax to pay when they receive the corpus. The result is that she would have been better advised to have given the property outright to her children and to have decided exactly what, if anything, she wanted to give to the Y, without considering the use of a trust such as has been sanctioned by our internal revenue laws for about 30 years.

The third example: Mr. C is a widower whose children have predeceased him, leaving no issue. He is presently in his seventies and his alma mater has been the residuary legatee of his will for a number of years. He desires to be as generous as possible, however, to the college during his lifetime. He lives in a retired status where his living expenses are pretty stable at around $20,000 per year. So he transferred substantially all his income-producing property to a trust, providing that it would currently pay all its income to the college, but each year would pay him $20,000 from the corpus; that is, pay back to him part of his own property.

Mr. C felt that in this manner he was able to get an unlimited deduction for the payment of income to charity while he consumed his capital. He realistically doubted whether he would live long enough to qualify for the unlimited charitable deduction, and through the proposed trust he received the satisfaction of making a large transfer to the college during his lifetime.

I need not tell you that the college, a small liberal arts college, was delighted to receive a trust of around $400,000, with the right to get the income currently, and to pay him this amount out of corpus each year.

Now, under the proposed bill, everything he gets back from his own corpus will be fully taxable as income each year, and so, instead of having the $20,000 per year to live on that he estimated would be necessary to meet his current standard of living, he would have $5,000 less.

My last example is a widow whose only daughter had predeceased her without issue. When she last revised her will in 1955, she had only two thoughts. She wanted to leave everything for charity, but she wanted to provide amply for a person who had looked after her

for many years. The person was not highly educated and she wanted him to have a fixed amount, if possible, after taxes, each year so that he would know how to govern his own expenses.

In 1955 it was possible to do this by merely providing that the trust would pay all its income to charity but would pay this small annuity out of corpus each year to her former servant.

However, under this new bill, if it is enacted, the amount received by the servant each year would be fully taxable.

In these four examples, we have charitable gifts that were made in reliance on the inducements in the law existing at the time the trusts were created. All our donors were very generous with their favorite charities.

Now, the results I have pictured under H.R. 9662 could easily have been avoided if the clients were to make the gift today. For example, in the two trusts to pay the income to charity and the corpus revert to the grantor, my first example, or to be distributed to a child of the grantor, my second example, the grantor could avoid having any portion of the income taxed to himself as remainderman by having the trust placed on a fiscal year ending November 30. Then the trust would have no income in the year of termination, which would be December 1, and there would be no problem.

In other words, this catches these people simply because it creates a policy that did not exist then. If they had known this, their instruments would have been slightly different and there would not have been this problem—it is just a trap for the guy who has already created a trust. It would not prevent anything in the future.

In the third example, the grantor could achieve exactly the same results as he could under present law by establishing a series of trusts with a corpus equal to the amount to be paid him each year. One trust would terminate each calendar year, with a short taxable year in the year of termination. The grantor could get the same result as he could under present law, but, by virtue of the trap built into this H.R. 9662, as it applies to irrevocable trusts already created, there would be a very real hardship.

The testator in my fourth example might do several things. The simplest would be a trust invested completely in tax-exempts that would pay its income to the individual, the private beneficiary, and provide that the corpus would be combined with that of the exclusively charitable trust upon the servant's death, or she might have decided on a commercial annuity that would have a small taxable portion.

The overshadowing effect of this provision in H.R. 9662, I think, was correctly forecast by the chairman of the board of trustees of one of our leading colleges. He stated to me that: "If Congress will do this once"—that is, taking away, penalizing a person who had relied on the inducements to make charitable gifts in existing law—"it might do it again. How can I tell a person he can afford to give the college a lot of money if there is a possible change in the law that means he cannot afford it?"

There is nothing in the House committee report to show that the committee was aware of the results that would follow in any one of my examples except the last one. In fairness to persons who relied on the inducements in present law to make charitable gifts, and in order to avoid discouraging prospective donors, I respectfully request that

the committee take favorable action on my amendment to restrict this change in the law to trusts created after H.R. 9662 was introduced in the House.

Thank you, Mr. Chairman.

The CHAIRMAN. Any questions?

Senator WILLIAMS. Just one question. If that amendment should be adopted, would you approve of the rest of the bill as it is before us?

Mr. HUFFAKER. I am appearing only on this one provision, and so far as the trusts that I represent, yes, sir. In other words, I think that Mr. Williams' points and those that are going to be made by the other witnesses have an awful lot of merit. But, so far as the four-tier system itself goes, I think there is a great inequity in it, which is to punish the people who have relied on existing law; therefore, I am restricting my amendment, Senator, to just limiting it to not making this applicable to existing trusts.

Senator WILLIAMS. I appreciate the fact, and I recognize what your amendment proposes to do, but my question is: What do you think of the proposed changes affecting all future established trusts?

Mr. HUFFAKER. My own feeling is that it is unsound, Senator. As I pointed out, it attempts to keep a person from doing something—that is, from setting up a trust of this sort—but it does not really do it. The only person in the future that it will catch is the person who did not have a tax-conscious adviser setting it up because he can get around it.

I think, by far, the best solution, Senator, is that in the American Bar Association bill which would say, "Distributions to charities will be treated exactly like distributions to private parties."

Senator WILLIAMS. That is all.

The CHAIRMAN. Thank you very much, Mr. Huffaker.

(The statement of Mr. Huffaker follows:)

STATEMENT OF JOHN B. HUFFAKER

My name is John B. Huffaker, 1617 Land Title Building, Philadelphia. I am appearing on behalf of a number of trusts that will be adversely affected by the proposed legislation. All of these trusts provide that the income is to be paid to charity and either during the term of the trust or on termination payments from corpus are to be made to individuals.

H.R. 9662 proposes a radically different treatment for trusts of these types. I understand that a number of witnesses will oppose the new method of taxing the individual beneficiaries of these trusts. If the committee decides to amend H.R. 9662 to continue present law as it applies to trusts of this sort or if it decides to follow the recommendation of the American Bar Association as reflected in section 31 of H.R. 10591, there is no need to give special consideration to the amendment I am proposing. However, if the committee decides that the rules in H.R. 9662 are desirable, I respectfully request that the bill be amended so that the extremely harsh results from the application to trusts established before H.R. 9662 was introduced in the House will be avoided.

This can be done by inserting at the beginning of section 661(a)(4), as it would be amended by section 106 of the bill, the following: "In the case of any trust created after January 18, 1960, or the estate of any decedent dying after January 18, 1960,". I feel there are two compelling reasons why this amendment should be accepted even if the new method of treating trusts that pay the income to charity is adopted for the future.

1. The new method is apparently intended to impose a prohibitory tax penalty on certain types of trusts. This represents a new congressional policy and is an attempt to discourage certain gifts to charity through trusts. However, it has long been the policy of Congress to encourage charitable gifts by providing special income tax benefits. This bill will change the law applicable to existing

trusts so that, in some cases, extremely inequitable results will follow. I do not think a person should be penalized for being charitably inclined.

2. If H.R. 9662 is enacted, persons who made gifts in trust to charity will not get the tax benefits from the gift that were provided by the law in effect at the time of the gift. We all recognize that most large charitable gifts not only reflect the philanthropic intentions of the donor but also the fact that the Government has encouraged these gifts by providing for an income tax deduction for the donor and in certain other ways. If the benefits offered to the donor for making the gift are withdrawn after the gift is made in this one instance, it is obvious that donors will be reluctant to make future gifts that are made economically possible by the benefits our tax law extends.

Under present law, whether a distribution from a trust to an individual is regarded as income for tax purposes depends on whether the distribution is made in whole or in part from "distributable net income." In the case of individuals who are to receive distributions of current income under the trust instrument, the distributable net income is determined by reference to the income and expenses of the trust and without taking into account any distributions to charity. However, with regard to distributions to other beneficiaries, the distributable net income is reduced by the amount of any income paid to charity. Thus, under present law, in the case of a trust which requires the current income to be paid to charity and an amount of corpus to be paid to an individual, the corpus distribution will be tax free since the distributable net income is zero.

The House committee felt that "where a trust makes distributions to both charitable and noncharitable beneficiaries to the extent they do not exceed distributable net income, distributions to tax-exempt charities should not be allowed to eliminate or reduce the taxable income of the noncharitable beneficiaries." Therefore, the House bill provides that "noncharitable beneficiaries must include in their income all amounts distributed, to the extent of distributable net income of the trust or estate, unreduced by any distributions to charity. Thus, if a trust instrument provides that all of its income is to be currently distributed to a charity, and an equal amount of corpus is to be paid to an individual beneficiary, the individual beneficiary would be taxed on the entire distribution up to the extent of the distributable net income."

To fully realize the significance of this change, I think we must review the tax rules relating to trusts that pay the income to charity and which the bill does not purport to change.

In the first place, the grantor may get a charitable-contribution deduction for the value of the gift to charity when he creates the trust. If the trust instrument provides for corpus payments to an individual, either while the trust continues or on termination, the value of this gift to the individual is taken into account in determining the amount of the gift to charity. The grantor is regarded as making a gift of a future interest to any individual to whom amounts of corpus are payable. Since it is a future interest, he does not get the annual $3,000 exclusion for gift-tax purposes.

Prior to 1954 the grantor could get a charitable deduction when he created the trust, even if the corpus reverted to him. By an amendment in 1954, effective as to transfers to trusts after March 9, 1954, no deduction is allowed if the corpus reverts to the grantor.

A second rule applicable to these trusts is that if the income of the trust is payable to a school, church, or hospital for at least 2 years, the grantor will not be regarded as receiving the trust income even if the corpus reverts to him after the 2-year period. This provision is especially designed to encourage giving by individuals whose total charitable gifts might exceed the maximum amount deductible if the donor was treated as receiving and then giving away the income of the trust paid to charity.

The third important rule applicable to trusts that pay the income to charity is that gifts and bequests are excluded from gross income except to the extent that the gift is of income from property. Thus, a gift to an individual is normally free from income tax although the property is to be held in trust to pay the income to charity for a period of years.

Congress has always shown that it regarded the support of our charities as important. Our tax laws offer the inducements that I have outlined to encourage gifts to charity. Every gift to charity that is made more attractive by these inducements, of course, represents tax avoidance. Let us consider a taxpayer in the 80-percent income tax bracket. If a $1,000 gift to charity is deductible, his income tax will be reduced by $800. Or, to put it another way, if the gift is not deductible (for example, his other charitable gifts equal the maximum per-

centage of his income that is deductible) and he made the gift from his income, then he must earn $4,000 to pay the tax on the $1,000 he gave to charity. Thus, I am not quite sure what the House committee report means when it mentions tax avoidance through charitable giving as if it were a novelty. Substantial charitable gifts by individuals in the higher income tax brackets are often induced or made possible by the tax benefits available to the donors.

Gifts to charity through trusts are usually by individuals who desire to make substantial gifts and who are in the higher income tax brackets. The importance of the large donor to our charitable institutions in their effort to meet the added responsibilities they must assume—I am thinking in particular of our schools, which educate our future leaders and scientists to carry the banner of the free world at the same time they are facing the responsibility of accepting greater numbers of students—is dramatically illustrated by the recent fund drive by Harvard. The 46,000 alumni gave a total of $82,500,000, with the largest single gift being for $2,622,000. While 30,573 alumni contributed, a total of $55,264,853 was received from 122 donors. I do not know how many of these donors used trusts of the type with which I am concerned, but it does show that the large donor is an extremely important source of funds for charity. I do not think many persons contribute to charity because of the tax benefits, but I do believe that the tax benefits made it possible for the donors to be so generous.

Now, I wish to call to the committee's attention four fairly typical gifts in trust to pay the income to charity. These trusts were all created prior to 1960, but the payments in 1960 and subsequent years will be subject to the new rules in H.R. 9662. The importance of these illustrations is to permit the committee to determine if the tax result that would follow if H.R. 9662 is enacted is the result it wants, and whether this precedent for applying new rules to charitable gifts already made will discourage other individuals from making gifts to charity. It is my contention that the enactment of H.R. 9662 in its present form would do much to nullify the inducements in our tax law to make charitable gifts.

ILLUSTRATIONS OF CONSEQUENCES OF MAKING CHARITY A FOURTH-TIER DISTRIBUTEE

1. Mr. A is in the 80-percent bracket. On December 1, 1958, he created a trust to pay the income to Y university for 2 years, and then for the corpus to revert to him. The trust has dividend income of $10,000 in each year and files its return on a calendar-year basis. On December 1, 1960, the corpus will revert to him.

Mr. A created this trust after being advised by his attorney that the income of the trust would not be taxed to him. This is important to Mr. A, since his other gifts to charity are so large that he could not give $10,000 per year and remain within the maximum limitation on charitable contributions. Therefore, he established the trust to take advantage of the express provision in the code that income of a trust for 2 or more years would not be taxed to the grantor if the income was payable to charity (sec. 673(b)). Under H.R. 9662, if the corpus reverts to Mr. A on December 1, 1960, he will be taxed on all the trust income for 1960. He placed shares of stock in trust and he will get the same shares back. Mr. A cannot understand why he should be taxed on the trust income in 1960 since it went to charity.

2. Mrs. B. was approached in 1959 by the local YWCA for a substantial gift. It was pointed out to her that if she made a gift in trust with the income to be paid to the YWCA for 3 years and then for the corpus to be paid to her children, the income tax deduction on the creation of the trust would more than offset the gift tax she would pay on the gift to her children. Her attorney advised her that Congress had specifically refused to change the law allowing a charitable deduction on the creation of trusts of this sort in 1958, so that there did not seem to be any substantial doubt as to the tax consequences. Acting on this advice, Mrs. B established a trust in December 1959.

If H.R. 9662 is enacted in its present form, her children will be taxed on the income of the trust in the year in which it terminates. Her children are grown and in substantial tax brackets themselves, so that the children will have a very substantial tax to pay when they receive the corpus. The result is that she would have been better advised to have given the property outright to her children and to have decided exactly what, if any, she wanted to give to the YWCA without considering the use of a short-term trust.

3. Mr. C is a widower whose children have predeceased him, leaving no issue. S College has been the residuary legatee of his will for a number of years, but

he wants to make a substantial present gift to the college. He lives rather simply and, since he is now 76 years old, he does not contemplate entering any new business ventures. He anticipates that his living expenses will be about $20,000 per year, so he established a trust into which he transferred practically all of his income-producing property with the provision that the income be paid to the college during his life and that he should be paid $20,000 out of corpus each year. It is provided that upon his death the remaining corpus will be paid to the college. Mr. C felt that in this manner he was able to get an unlimited deduction for the payment of income to charity while he consumed his capital. He realistically doubted whether he would live long enough to qualify for the unlimited charitable deduction, and through the proposed trust he received the satisfaction of making a large transfer to the college during his lifetime.

Mr. C has now been informed that under the proposed legislation he will be taxed on the full amount that is to be distributed to him in each year. He had recognized that a small portion of the income of the trust would be taxed to him anyway, because he had a reversionary interest in a portion of the corpus within 2 years. However, under the proposed bill, he will have a tax of about $5,000 in each year.

4. Mrs. D was a widow and her only daughter had predeceased her without issue. When she last revised her will in 1955, she stated that she wanted the bulk of her estate to go to charity, except that she wanted to provide liberally for an individual who had served her long and faithfully. She was anxious that the amount paid each year to her employee should be free from tax so the employee would know exactly how much was available for his living expenses. A trust was provided in her will under which the income was paid to charity and the trustees had the right to invade corpus for the benefit of charity. An amount was to be paid each year from corpus to the named individual.

Mrs. D died in 1956 and the trust has been duly established. The beneficiary named has been informed that the amount received each year is nontaxable. However, under the proposed bill, the amount distributed to the individual would all be taxable income.

If Mrs. D were considering creating such a trust today, her attorneys would recommend different plans for her will. They might recommend separate trusts; they might recommend a commercial annuity which would have a small taxable portion or other methods that would accomplish substantially the same end result that the testator desired. However, this bill will frustrate her intentions.

In these four examples we have charitable gifts that were made in reliance on the inducements in the law existing at the time the trusts were created. Now, the results I have pictured under H.R. 9662 could easily be avoided if the clients were to make the gifts today. For example, in the two trusts that were to pay the income to charity and then the corpus was to revert to the grantor (my first example) or be distributed to a child of the grantor (my second example), the grantor could avoid having any portion of the income taxed to himself or the remainderman by having the trust placed on a fiscal year ending November 30. Then the trust would have no income in the year of termination and there would be no problem.

In example 3 the grantor would establish a series of trusts with a corpus equal to the amount to be paid him each year. One trust would terminate each calendar year with a short taxable year in the year of termination. Thus the grantor would not be taxed on any greater portion of the ordinary income of the trusts than he would be under present law although he would have the nuisance that multiple trusts entail. The added complications might deter him from making the gift at all, with the result that the college would receive liberal annual gifts but could not have the certainty that accompanies the trust. Being familiar with this particular grantor, it is very unlikely he would have been so generous. And it is this grantor who will actually suffer if the legislation is enacted.

The testator in my fourth example might do several things. The simplest would be a trust invested completely in tax-exempts that would pay its income to the individual and provide that the corpus will be combined with that of the exclusively charitable trust upon his death. Or she might have decided on a commercial annuity that would have a small taxable portion.

Thus there would continue to be alternatives open to grantors with the same desires as I have outlined. However, the irrevocable trusts created

under present law fall into the trap this legislation represents because the policies it declares did not exist at that time. And I guess a few dollars of revenue will be collected from new trusts that are drafted by general practitioners who do not read the latest list of pitfalls.

The overshadowing effect of H.R. 9662, I think, was correctly forecast by the chairman of the board of trustees of one of our leading eastern colleges. He stated that "if Congress will do this once, it may do it again. How can I tell a person he can afford to give the college a lot of money if there is a possible change in the law that means he can't afford it?"

There is nothing in the House committee report to show that the committee was aware of the results that would follow in any of my examples except the last one. In fairness to persons who relied on the inducements in present law to make charitable gifts, and in order to avoid discouraging prospective donors, I respectfully request that the committee take favorable action on my amendment to restrict this change in the law to trusts created after H.R. 9662 was introduced.

The CHAIRMAN. The next witness is Mr. Rodney C. Lockwood.

The next witness is Mr. William R. Spofford, American Bar Association.

Take a seat, sir, and proceed.

STATEMENT OF WILLIAM R. SPOFFORD, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY NORMAN SUGARMAN AND DONALD McDONALD

Mr. SPOFFORD. If the committee pleases, I am William R. Spofford, of Philadelphia, chairman of the Section on Taxation of the American Bar Association. I should like very much to introduce the two gentlemen who are accompanying me. On my left is Mr. Norman A. Sugarman, of Cleveland, who is the chairman of the tax section's committee on income of estates and trusts.

On my right is Mr. Donald McDonald, of Philadelphia, who is chairman of the section's committee on partnerships.

On February 22, 1960, the House of Delegates of the American Bar Association, upon recommendation of the section of taxation, adopted a resolution directing the section to urge the Congress not to enact (at this time) the provisions of section 101, certain provisions of section 108, and section 113, of H.R. 9662.

The resolution so adopted is as follows:

Resolved, That the American Bar Association recommends to the Congress that it do not enact (at this time) the provisions of section 101 (relating to legal life estates and other terminable interests), section 108 (relating to gifts, bequests, etc., of specific sums of money, or of specific property) so far as it relates to proposed section 663(a)(2) of the Internal Revenue Code of 1954, and section 113 (relating to multiple trusts) of H.R. 9662 until such time as persons affected may have sufficient opportunity to consider these provisions and make appropriate comments to the proper committees of Congress; and be it further

Resolved, That the section of taxation is directed to urge this recommendation upon the proper committee of Congress.

The reasons for urging this action upon the Congress at this time are as follows:

The Advisory Group on Subchapter J after extended consideration covering a period of several years rendered exhaustive reports, revised on several occasions to reflect views of interested parties and finally reflected in H.R. 3041 introduced January 21, 1959.

This proposed legislation has been carefully considered by a committee of the section of taxation which after many months of consideration was prepared to make recommendations to the section upon the advisory group report on subchapter J and H.R. 3041.

On January 18, 1960, H.R. 9662 was introduced, which superseded H.R. 3041 insofar as the subchapter J provisions are concerned, and H.R. 9662 was reported out by the Ways and Means Committee without public hearing, and was passed by the House of Representatives on February 4, 1960.

Section 101 of H.R. 9662 contains novel proposals and does not contain the provisions contained in H.R. 3041 or in the advisory group report. Section 108, which relates to gifts, bequests, and so forth, has adopted an approach substantially at variance with the proposal of H.R. 3041 although addressed to a problem and policy adverted to in the advisory group report. Section 113 contains a proposal at variance with that of H.R. 3041 and based upon a policy materially different from that adverted to in the advisory group report.

All of the sections referred to have a material effect upon practice in the trust and probate law as well as the law of taxation. The American Bar Association considers these matters of sufficient importance to be the subject of extensive public consideration and comment.

The committee of the section of taxation charged with the consideration of this legislation during the short time available to it has already pointed out serious problems raised by these three sections and has indicated the urgent need for further careful consideration by it and for cooperation and liaison with the Section on Real Estate, Probate, and Trust Law of the American Bar Association.

The resolution adopted by the house of delegates on February 22, 1960, should not be construed as approval or disapproval of other provisions of H.R. 9662 except to the extent that prior actions taken by the American Bar Association are applicable thereto.

The American Bar Association has a number of other legislative recommendations in the subchapter J and subchapter K areas. Just a year ago we submitted to the Ways and Mean Committee of the House of Representatives four legislative recommendations dealing with subchapter J. Those recommendations have been adopted in H.R. 9662. At that time, a year ago, we submitted 15 recommendations relating to subchapter K. Since that time, the annual meeting of the American Bar Association was held in Miami in August of 1959, and at that meeting five additional legislative recommendations relating to subchapter K were adopted. There has not been an opportunity to submit the legislative recommendations adopted last August to the Ways and Means Committee at a formal hearing, but they have been submitted on an informal basis and the staff of the Joint Committee is informed of all actions taken by the American Bar Association to date.

Our 21 legislative recommendations in the subchapter K area have not fared as well as our four in the subchapter J area. Of the 21 in the subchapter K area, 8 have been adopted, 7 have been adopted with material change, and 6 have not been adopted.

However, in the case of those that were adopted with material change, our committee points out very serious technical complications.

All the legislative recommendations heretofore adopted by the American Bar Association which originated in the section of taxation have been included in one bill. This bill was prepared by our committee on legislative recommendations and introduced in the House at our request by Mr. Mills, chairman of the Ways and Means Committee, on February 23, 1960.

A similar bill was introduced by Mr. Mason, the ranking minority member of the committee, also at our request. These bills are known as H.R. 10591 and H.R. 10592, respectively. A detailed explanation of the bills prepared by the section of taxation has been printed in the Congressional Record.

We do not offer these bills or the explanation for the record of this hearing. The staff of the Joint Committee is, we are quite certain, entirely familiar with the contents of the bills as well as the explanations, and our purpose in referring to them at this time is merely to point them out to this committee for such reference thereto as the members of the committee may wish to make. It is our hope that these bills and our explanation will serve as a useful source of reference to the Members of the Congress, the Treasury, the American Bar Association, and the taxpayers of this country.

Unless the members of this committee desire us to do so, we will not discuss any of the details of H.R. 9662 or of the American Bar Association bills, H.R. 10591 and H.R. 10592, at this time, but we shall be pleased to meet with members of the staff, as we have in the past, to discuss our recommendations relating to subchapters J and K and, indeed, any other areas in which we have legislative recommendations.

In closing I should like to repeat what we said before the Ways and Means Committee a year ago. We think the advisory groups have rendered a very valuable public service, and we take pride in the fact that many of those serving on the groups are also active members of the Tax Section of the American Bar Association. They are men of outstanding ability in the tax field, whose views are highly respected by the section and the association.

On behalf of the American Bar Association and the section of taxation, we wish to thank you for this opportunity to appear before your committee.

The CHAIRMAN. Thank you very much, Mr. Spofford. Any questions?

Senator WILLIAMS. Mr. Spofford, as I understand it as a result of a recent decision, the necessity for section 101 has been eliminated; is that correct?

Mr. SPOFFORD. I learned that Mr. Glasmann, in effect, withdrew any endorsement of that section by reason of a recent circuit court opinion. I understand he so testified yesterday.

The CHAIRMAN. Do the other gentlemen have any statements to make?

Mr. SUGARMAN. Mr. Chairman, we are here to lend support, and to answer any technical questions that the committee may put to us.

The CHAIRMAN. Thank you very much, gentlemen.

The committee will recess until 10 o'clock tomorrow morning.

(Whereupon, at 11:40 a.m., the hearing was recessed, to reconvene at 10 a.m., Friday, April 22, 1960.)

TRUST AND PARTNERSHIP INCOME TAX REVISION ACT OF 1960

FRIDAY, APRIL 22, 1960

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10:15 a.m., in room 2221, New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd, Williams, and Bennett.

Also present: Elizabeth B. Springer, chief clerk; and Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order.

The first witness is Mr. George Craven, of the Philadelphia Bar Association, accompanied by Mr. David H. Dohan. Take a seat, gentlemen, and proceed.

STATEMENT OF GEORGE CRAVEN, ON BEHALF OF PHILADELPHIA BAR ASSOCIATION, ACCOMPANIED BY DAVID H. DOHAN

Mr. CRAVEN. Mr. Chairman, I wish to express the views of the Committee on Taxation of the Philadelphia Bar Association on the portions of H.R. 9662 which relate to estate and trust income. We have filed a memorandum setting forth objections to four provisions of the bill relating to estate and trust income, and our recommendations for relief in two other areas. In this brief period of time I shall touch briefly on our six points.

Our first objection relates to the provisions on multiple trusts. The bill proposes to deal with multiple trusts by adding a 10-year throwback rule. When a beneficiary receives a distribution of accumulated income from more than one trust created by the same grantor, the rule does not apply to the distribution from the first trust. As a distribution is made from any subsequent trust, the 10-year throwback rule comes into play and the beneficiary is required to report any income accumulated by trusts during the preceding 10 years as if he had received income in each of those 10 years.

Our particular objection is that the rule would apply without exception to trusts already in existence as well as to those created in the future.

We feel that any statute designed to deal with multiple trusts must necessarily be complicated. We doubt that the amount of revenue involved would justify adding such a complicated statute to the income tax law. We have not been able to obtain any specific information on this point. In any event, we are convinced that if the

multiple-trust problem must be dealt with, the throwback approach is the wrong way to deal with that problem or, for that matter, with any other problem relating to accumulated income.

Our experience with the 5-year throwback rule enacted by the 1954 code leads us to believe that its provisions are so complex and the difficulty of computing tax under it so great that it is almost incapable of administration.

The problem would be much worse under a 10-year throwback. If it is deemed necessary to have a statute dealing with the multiple-trust problem, we think the statute proposed by the Advisory Group on Subchapter J represents a much sounder approach.

Under that statute, if several trusts for accumulation of income are created by the same grantor for substantially the same ultimate beneficiaries, the accumulated income would be thrown together and all the trusts would be treated as one entity for the purpose of the computation of the tax.

The advisory group, however, recognizes that there may be perfectly sound reasons for creating more than one trust for the same beneficiary. The grantor may create a small trust in one year for a beneficiary and then, several years later when he has more money, he may want to create another trust, but because he doesn't like the provisions of the prior trust or the trustee, he may create a wholly separate trust, and the advisory group would not apply its rule unless the same grantor creates more than three trusts for the same ultimate beneficiaries or more than two such trusts are created within 5 years of one another.

It would avoid the objectionable retroactive feature of the present bill by excepting from its provisions all but the more flagrant type of trusts, and we object to the treatment of multiple trusts under the present bill, and we object specifically to making the statute apply without exception to trusts already in existence.

Our second objection relates to the treatment of charitable distributions. H.R. 9662 would change the treatment of income paid to or set aside for charitable organizations by treating charitable distributions as what may be termed fourth-tier distributions.

As a result, if all the income of a trust is paid to a charity, and payments from principal of the trust are made to an individual, those payments of principal would be taxed to the individual as if he had received the income.

If a trust which has a charitable beneficiary and an individual beneficiary pays deductible items from corpus, those items would be charged wholly against the share of income which goes to the charitable organization, and the individual beneficiary would not be given the benefit of any of those deductions.

We consider this proposal highly objectionable. We feel that an individual who receives a distribution from a trust should not be caused to pay a higher tax burden on that distribution merely because another beneficiary is a charitable organization rather than another individual.

We feel that if it is considered desirable to tax income which is paid to a charitable organization, the income should be taxed to the charitable organization and not to an individual who receives a distribution of principal.

Moreover, where all the income is distributed currently, we feel that there would be serious constitutional doubt about the right to tax as income a distribution made from the principal of the trust.

Of course, this problem could be easily avoided in future years by creating separate trusts for individuals and charities, but we do not feel that individual beneficiaries should be penalized by the present statute merely because in the past these trusts have been created under the rule now in force.

Our third objection relates to distributions of corpus of a decedent's estate. Under the 1954 Code presently in force, a distribution of corpus of a decedent's estate is treated as a distribution of income subject to the limitation that the total distributions taxable to all beneficiaries cannot exceed the distributable net income of the estate for the taxable year.

The only corpus distributions which are not treated as distributions of income are amounts paid in satisfaction of specific devises and bequests. This is one of the most widely criticized provisions of the 1954 Code. It results in distortion of income among beneficiaries of an estate; it causes beneficiaries who receive distributions of corpus to be taxed on more than their proportionate share of the income; and it makes it necessary to delay unduly the termination of the administration of an estate in order to prevent a legatee from being taxed on more than his share of the income of the estate.

The Advisory Group on Subchapter J proposed that an estate be permitted to make any distribution of corpus free of income tax within 36 months after the decedent's death. We think that would be a desirable amendment.

The advisory group proposed, further, that, if that proposal is not adopted, then in any event an amendment should be enacted making it possible to distribute any property actually owned by the decedent at the time of his death without having it treated as a distribution of income.

H.R. 9662, on the other hand, extends the exemption from income treatment only to distributions of real property and tangible personal property such as the family car, jewelry, and works of art owned by the decedent at the time of his death.

We think that the advisory group proposal on this point should be adopted or that, in any event, the statute should permit the distribution free of income tax of any property owned by the decedent at the time of his death, whether real or personal, tangible or intangible.

Our next objection relates to a rather minor point relating to corpus deductions of an estate or trust.

Under the present law, if an estate or trust pays a deductible item from corpus, the deduction reduces the income which is taxable to the income beneficiary. It does not reduce the capital gain, the tax on which is borne by the ultimate remainderman of the trust.

H.R. 9662 would reverse that treatment by allowing the deduction first as an offset to capital gain, and to the extent of any excess to the income beneficiary. We think that is a very desirable amendment. However, the bill does not adopt a proposal of the advisory group on one point, and that is where the estate or trust computes the tax on long-term capital gain by the alternative method, the flat 25-percent rate.

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Where the alternative tax method is used, no deductions are available to offset capital gain. The advisory group proposal in that situation would allow deductions in full to the beneficiary. The bill, however, would reduce the corpus deductions available to the income beneficiary by the full amount of capital gain, regardless of whether the alternative tax method is used or not.

We feel that the advisory group proposal should be adopted on that point.

Now, in our fifth point, this relates to certain relief from the 5-year throwback rule.

Under the 1954 Code now in force the 5-year throwback rule comes into play when distributions made by a trust from principal or income exceed by more than $2,000 the distributable net income of the estate or trust for the current year.

If a trust pays more than $2,000 of deductible items from corpus which reduce distributable net income but do not reduce income distributable under State law, the 5-year throwback rule comes into play.

The advisory group proposed that that result be corrected by an amendment. That amendment is not adopted in this bill, and we feel that it is a desirable amendment.

We urge, further, that the minimum amount which would cause the throwback rule to apply be increased from $2,000 to $5,000 to avoid the application of the extremely complex and difficult provision to very small amounts of income.

Finally, we think some relief should be granted from the double taxation on so-called income in respect of a decedent which, in general, means income accrued to a decedent at the time of his death.

That income is subjected to estate tax in the decedent's estate, and, when the decedent's estate collects the income, it is also taxed as income to the estate.

Some measure of relief from the double taxation is provided by allowing the estate to take an income tax deduction for the estate tax paid on this accrued income. However, the deduction for estate tax is not allowed for the gross amount of Federal estate tax, but is limited to the net Federal estate tax; that is to say, the estate tax reduced by the credit for State and foreign death taxes and for gift tax.

As a consequence, the estate tax and the income tax may amount to more than 100 percent of the income. For example, if a decedent's estate is in the 77-percent estate-tax bracket, and this income in respect of a decedent amounts to $10,000, the estate tax would be $7,700, leaving $2,300 of income after the estate tax.

Now, instead of allowing an income tax deduction of $7,700, the income tax deduction is limited to $6,100, the amount of the estate tax reduced by the credit for State death tax, and, if the estate is in the 70-percent income tax bracket, the two taxes together would amount to more than 100 percent of that income. We feel that that could be corrected by a very simple amendment which has been proposed by the advisory group, and we urge the adoption of that amendment.

Finally, we feel that the bad features of this bill relating to estate and trust income decidedly outweigh any good features of the bill.

Thank you, sir.

The CHAIRMAN. Thank you.

(The prepared statement of Mr. Craven follows:)

COMMENTS BY PHILADELPHIA BAR ASSOCIATION, COMMITTEE ON TAXATION, BEFORE SENATE FINANCE COMMITTEE ON PORTION OF H.R. 9662 RELATING TO SUBCHAPTER J: ESTATE AND TRUST INCOME

This memorandum is submitted to the Senate Finance Committee by the Committee on Taxation of the Philadelphia Bar Association to set forth our objections to certain portions of H.R. 9662 which amend subchapter J of the Internal Revenue Code of 1954, relating to estate and trust income, and our recommendations for further amendments.

SUMMARY

We urge that H.R. 9662 be modified insofar as it amends or fails to amend provisions of subchapter J of the code affecting the following problems relating to estate and trust income:

1. Multiple trusts.
2. Distributions to charitable beneficiaries.
3. Distributions of corpus by an estate.
4. Treatment of corpus deductions where tax on long-term capital gain is computed by the alternative method.
5. Relief from certain results of the 5-year throwback rule.
6. Deduction for estate tax on "income in respect of a decedent."

DISCUSSION

Our comments on these problems and our recommendations for changes in H.R. 9662 are set forth below.

1. Multiple trusts

H.R. 9662 proposes to deal with multiple trusts by adding to the code as section 669 a 10-year throwback rule. That section provides in substance that, after a distribution has been made to a beneficiary of accumulated income of a primary trust, if a distribution of income is subsequently made of accumulated income of a second or subsequent trust created by the same person, income accumulated by the subsequent trust in each of the preceding 10 years will be taxed to the beneficiary as if it had been received by the beneficiary in those years. The rules relating to the character of income would not apply and, presumably, tax-exempt income and other classes of income of the trust would be treated in the hands of the beneficiary as fully taxable income. The usual exceptions to the throwback rule would not apply. Although the statute and committee reports are not clear on this point, the throwback treatment might be construed to apply to testamentary as well as inter vivos trusts where the property originated with the same person.

The proposed statute is designed to deal with tax avoidance. We have been unable to ascertain, even after inquiry, whether a sufficient amount of revenue is involved to justify including such an intricate and cumbersome provision in the income tax statute. Even if multiple trusts are of sufficient importance to justify being dealt with in the statute, we do not think a throwback rule is a proper method of dealing with the problem. The 5-year throwback presently in force is very difficult to understand and administer and imposes serious burdens on fiduciaries and beneficiaries in attempting to compute the tax payable currently on income received by trusts in 5 prior years. These problems would be greatly accentuated by a throwback rule which requires the recomputation of income tax for 10 preceding years.

The advisory group on Subchapter J proposed to deal with multiple trusts by combining for the purpose of computing current income tax two or more trusts created by the same grantor with accumulation of income for substantially the same income beneficiaries. If legislation is needed in that area, we think the approach of the advisory group is sounder and less cumbersome than that proposed in H.R. 9662.

The operation of the proposed 10-year throwback would be wholly arbitrary. In one case the distribution from the primary trusts, which is exempt from the throwback rule, might be large, and the distribution from the second or subsequent trusts, which is subject to the rule, might be small, so that very little income would be taxed under the penalty throwback. In another case

the reverse might be true. The effect of the throwback rule would depend entirely on the order in which the trusts happened to terminate.

The proposed section 669 is particularly objectionable in applying without exception to trusts already in existence as well as those which might be created in the future, without regard to whether two or more trusts were created by the grantor bona fide reasons or whether a number of trusts were created for tax-avoidance purposes. There are often good reasons for creating a second trust for the same beneficiaries instead of making additions to a trust already in existence. The statute proposed by the advisory group recognizes that exceptions should be made in cases where the trusts were not set up for tax-avoidance purposes and provides that the multiple-trust statute shall not apply to trusts already in existence unless a specified number of trusts were created for the same ultimate beneficiaries. Likewise, under the advisory group proposal, testamentary trusts would not be combined with trusts created by the testator during lifetime. We think those exceptions should be incorporated in any statute which deals with multiple trusts.

Finally, insofar as the 10-year throwback would result in imposing a tax on tax-exempt income, it would run counter to long established rules of income tax law that income received through a trust retains its same character in the hands of a beneficiary. Also, there would be doubt about the constitutionality of a statute which imposes income tax on interest on State and municipal bonds.

We doubt that the multiple-trust problem is of sufficient importance to justify a statute which would impose such severe burdens on fiduciaries and beneficiaries. If legislation is considered desirable, we think the statute proposed by the advisory group is preferable to that proposed in H.R. 9662. In any event, if a statute is enacted, it should provide exceptions in the case of bona fide accumulation trusts now in existence.

2. Charitable distributions

As a step in the direction of simplification, H.R. 9662 proposes to treat charitable distributions as distribution deductions rather than as deductions from gross income, as under existing law. We think this is a step in the right direction and approve such treatment of charitable distributions.

However, H.R. 9662 in the propsed section 661(a) goes further and treats all charitable distributions as fourth-tier distributions. This means that if all the income of a trust is distributed currently to a charitable organization and distributions of principal are made to an individual, the distributions to the individual would be taxed as if they were distributions of income. If part of the income is payable to a charitable organization and part is payable to an individual, deductible items paid from corpus would not be allowed to reduce the income taxable to the individual, but would be charged wholly against the charitable distribution, which is not taxable. Thus, an individual who is beneficiary of a trust which provides for income distributions to charities would be required to pay a higher tax than have to pay if the other beneficiaries were individuals.

We see no justification for the proposed treatment of charitable distributions, and urge that the prop sed statute be changed so as to treat charitable beneficiaries in exactly the same way as individual beneficiaries.

The report of the House Ways and Means Committee on H.R. 9662 states (p. 10–11) that one of the reasons for placing charitable distributions in the fourth tier is "to preclude the possibility of tax avoidance." We fail to see that any tax avoidance is involved.

If a trust should accumulate income for a charity and make current distributions of principal to an individual, it might be desirable, in order to prevent tax avoidance, to provide that the distributions of principal shall be taxed to the individual as distributions of income. In that situation the income accumulations keep the principal intact. But if all the income is paid currently to a charity and the principal is depleted by amounts which are distributed to an individual, we know of no sound reason why the individual should be taxed as if he had received distributions of income. In fact, in a case where all the income is distributed, there would be doubt about the constitutionality of a statute which taxed the distributions of principal as if they were distributions of income.

If a grantor creates a trust to pay all the income to charity and he pays amounts annually to an individual from his own capital which does not go into the trust, no one would contend that the payments of capital should be taxed as income to the individual recipient. It could not be said that the payments to the

individual are income within the meaning of the 16th amendment. Likewise, if the grantor created one trust to pay income to charities and another trust to pay principal and income to an individual, the individual would not be taxed on the amounts of principal received by him. We fail to see why an individual should be taxed on payments made from principal of a trust merely because the income beneficiary is a charitable organization.

The proposed statute is particularly objectionable in its application to trusts already in existence. The application of the statute in the future could be avoided by setting up separate trusts for individuals and charities. Individual beneficiaries of trusts already in existence should not be penalized by a retroactive amendment which would cause them to bear higher tax burdens merely because other beneficiaries of the trust are charitable organizations.

If the income distributed to charity is to be treated as a distribution deduction, it is our view that charitable organizations should be treated in the same way as individual beneficiaries and that income which is in fact distributed to charitable organizations should not be taxed to individual beneficiaries as if it had been distributed to them.

3. Distributions of corpus of an estate

One of the most widely criticized provisions of subchapter J of the 1954 code is that which causes distributions of principal of a decedent's estate to be taxed as distributions of income in an amount not in excess of distributable net income for the year of distribution. The only exception to this rule in existing law is amounts paid on account of specific bequests and devises. The reason for this provision is not clear, as there is nothing in the congressional committee reports on the 1954 code which states the reason for its enactment.

As a result of this provision, where a distribution of principal is made to a residuary legatee during the period of administration of the estate, the legatee may be taxed on income which he can never receive. It is often necessary for an estate to retain income to meet future liabilities payable from income, such as interest on estate and inheritance taxes. In order to prevent a distribution of principal from being taxed to a legatee as if it were income, it is necessary to delay distributions of principal until the administration of the estate is completed. This may result in prolonging unduly the period of administration. A decedent's estate is not a tax-avoidance device, and the income tax laws should not operate in such manner as to interfere with the orderly administration of an estate.

The extension of the separate-share rule to estates by H.R. 9662 will alleviate to some extent the harsh results produced by this rule and will prevent a beneficiary who receives a distribution of principal from being taxed on more than his proportionate share of the income of the estate. However, the beneficiary may still be taxed on income which he will never receive.

The Advisory Group on Subchapter J proposed an amendment to section 663(a) of the code which would exempt from income treatment any distribution of principal made by an estate within 36 months after the decedent's death. We think that is a most desirable amendment. However, H.R. 9662 omits the advisory group proposal and extends the exception from income treatment only to distributions of tangible personal property. That amendment does not permit the distribution free of income tax of securities or other intangible property owned by the decedent.

We strongly urge that the proposal of the advisory group be adopted. If that proposal is not adopted, we urge in the alternative that section 663(a) be amended to permit the distribution free of income tax of any property (with the possible exception of money) owned by the decedent at the time of his death.

4. Treatment of corpus deductions where tax on capital gain is computed by the alternative method

Following a proposal of the Advisory Group on Subchapter J, H.R. 9662 amends section 643(a) so as to allow deductible items paid from corpus primarily as an offset to net capital gain which is taxable to the estate or trust. Any excess of corpus deductions over such capital gain is allowed as a deduction in computing distributable net income. We approve this amendment. However, H.R. 9662 omits one important provision of the advisory group proposal.

Under the advisory group proposal, where the estate or trust computes tax on long-term capital gain by the alternative method, so that no such deductions would be allowable as an offset to such capital gain, the corpus deduction would be allowed in full to income. H.R. 9662 would reduce corpus deductions allow-

able to income by the amount of capital gain taxable to the estate or trust, whether or not the alternative computation is used. The result under that amendment would be that, if the alternative tax computation is used, corpus deductions not exceeding net long-term capital gain would not be allowed to anyone.

The purpose of the amendment is to remove an inequity in existing law by allowing such deductions to corpus to the extent that they can be used by corpus. If there is no capital gain, they are allowable wholly to income. Similarly, if there is capital gain, but because of the alternative computation the deductions are not allowable against capital gain, there is no reason to deprive income of the deductions.

We urge that the proposal of the advisory group be adopted and that, where the estate or trust computes tax on capital gain by the alternative method, corpus deductions be allowed wholly to income.

5. Relief from certain results of the 5-year throwback rule

Another provision of subchapter J of the 1954 code which has been widely criticized is that which imposes the 5-year throwback rule. The statutory provisions enacting this rule are so difficult to understand and apply that the throwback rule is largely ignored by all except experts in the field of fiduciary income tax. If the throwback rule is retained in the law, it is important that remedial amendments be enacted. H.R. 9662 contains some desirable amendments to the throwback rule, but fails to include others which are equally desirable.

As the throwback rule now operates, if a trust pays deductible items from corpus, since the corpus deductions reduce income which is taxable currently to beneficiaries but does not reduce income which is distributable under State law, distributions to beneficiaries will exceed distributable net income and will result in an "accumulation distribution" under the throwback rule. This may cause a beneficiary receiving current income to be taxed as if he had received income of the trust for a prior year. This is probably an unintended result.

The Advisory Group on Subchapter J proposed to change this result by amending section 665(b) to define an accumulation distribution to mean the amounts by which income distributions exceed either income under State law or distributable net income, whichever is greater. H.R. 9662 fails to include the amendment so proposed by the advisory group.

We urge that the advisory group proposal on this point be adopted.

Under existing law the throwback rule applies if distributions to beneficiaries of a trust exceed by more than $2,000 the distributable net income of the trust for the current year. It is thus necessary to apply the complex throwback rules to relatively small income distributions. We think the burden of the throwback rules would be reduced substantially, without an appreciable loss of revenue, if the limit is increased from $2,000 to $5,000, and we urge that section 665(b) of the code be amended to make such increase.

6. Allowance of deduction for full amount of estate tax on income in respect of a decedent

The Advisory Group on Subchapter J proposed amendments to section 691 of the code, relating to income in respect of a decedent, which would (1) define income in respect of a decedent and (2) allow an income tax deduction for the gross amount of Federal estate tax on such income, in lieu of the deduction under existing law of the gross Federal estate tax reduced by the credits against such tax for State and foreign death taxes and gift tax. H.R. 9662 omits such amendments.

It is probable that additional time is required to consider the proposed definition of income in respest of a decedent. However, the amendment relating to the deduction of the estate tax is simple, should not require further consideration, and should be adopted in the present bill.

It is pointed out on page 11 of the final report of the advisory group, dated December 30, 1958, that failure to allow a deduction for the gross amount of the Federal estate tax results in some cases in the imposition of estate and income taxes in excess of 100 percent on income in respect of a decedent. We do not think this result should be permitted to continue, and we recommend that the amendment proposed by the advisory group, allowing an income tax deduction for the gross Federal estate tax, be enacted at this time.

The CHAIRMAN. Mr. Dohan, do you have a statement to make?

Mr. DOHAN. Yes, sir.

The CHAIRMAN. Do you desire your full statement to be put in the record?

Mr. CRAVEN. Yes, your honor, I have a longer statement—you mean the abbreviated statement?

The CHAIRMAN. You have got two statements here.

Mr. DOHAN. One, Mr. Chairman, is on subchapter J which Mr. Craven has handled, and I am going to handle the subchapter K report.

The CHAIRMAN. Proceed.

Mr. DOHAN. The subchapter K amendments made by H.R. 9662 are, to put it somewhat bluntly, in bad need of overhaul. These amendments have been characterized as noncontroversial, being confined, it is said, to minor changes and clarification of existing law.

But this is not the fact, for in many areas substantive changes have been made, and yet in extending existing law, the draftsmen have not been aware of the consequences of what they have done. They have not thought through the effect of the changes that they have made.

As an example, we have the basis rules in section 705 of the present law.

As you know, there is a general rule and an alternative rule, and the effect of the advisory group report was to turn those rules around and make the alternative and simpler rule the general rule, and make what has been the general and more complicated rule an alternative.

Much more importantly, the advisory group recommended that the person who wishes to show a difference between the two methods should have the burden of proof, which means the revenue agent. That important provision has been deleted, and yet here we are with a new section 705 that does nothing more than turn around the rule and leaves us all exactly where we were.

Another example of inept draftsmanship: 702(e), which is a new subsection added to provide a simplified method of reporting. The price of this simplified method of reporting is the denial of charitable deductions and denial of other deductions based on a fixed amount or a percentage of income.

Thus exploration expenditures are eliminated, percentage depletion, and if a partnership is uncharitable, it cannot take a deduction.

Furthermore, the partnership must be composed only of individuals. No corporations, trusts, or estates may be partners.

Now, if a partnership wishes to report its income under this simplified method, it need not have a special simplified method with these restrictions. It can use the regular form without complication. Our belief is that this section adds very little, if anything, to subchapter K.

The committee on taxation has felt the necessity for simplification to be greater here in this subchapter than perhaps almost any other in the code. As an example of our belief that it can be simplified, section 702 deals with the determination of the character of income. Under the present law, and the advisory group's report, the character is to be determined at the partner level. This has been added to by the draftsmen of H.R. 9662 to insert a provision that the character while determined at the partner level is to be determined with due regard for the activities of the partnership. As a consequence, one partner can be treated differently than another.

There is one example in the committee report of a partner who is a member of three partnerships, and the three partnerships inde-

pendently of each other sell a piece of real estate. The partner himself, who is a common partner in all three, does nothing, and is not a real estate dealer; yet under the proposal he can be held to be such.

Now, the revenue effect of determining income at the partner level is minimal. There is no suggestion in the House report that the amounts involved are anything else.

The American Bar Association has recommended that the character of income be determined at the partner level. This rule has the great advantage of simplicity. It will facilitate administrative determination in the field of these questions, and our committee heartily endorses that suggestion.

Next are the collapsible partnership rules. Under present law these rules are applicable to sales and distributions where substantially appreciated inventory and unrealized receivables are present.

The advisory group report, in an effort to simplify the statute, eliminated the distribution rules from section 751.

Now, to prevent revenue leakage, they removed from another section a provision which said that inventory upon distribution to a partner would retain its character in his hands for 5 years. They went further and provided that inventory would retain its character in his hands or the hands of a transferee of his who took a substituted basis or a donee. They felt that adequately protected the revenues.

Now, the draftsmen of H.R. 9662 have restored the distribution rules but they have not reinstated the 5-year provision of section 735.

If the distribution rules are to be reinstated in what is now section 751, our committee believes that the 5-year rule also should be reinstated, in other words, as under the existing law.

A second comment under collapsible partnership rules; they provide that if there is an overall loss on the sale of an interest, there nevertheless is ordinary income realized by the partner if the sale of inventory items results in a profit.

The advisory group recommended, as does our committee, that the rule not apply at all if there is not an overall profit. This is a simplification measure and again the revenue considerations are minimal.

If the present rules are to be reinstated as contained in H.R. 9662, we recommend that there be inserted a provision which allows the partner to take an ordinary loss on the inventory assets when they are sold, whether or not there is an overall loss on the transaction.

Senator WILLIAMS. May I interrupt for a moment. In a case where there would be a profit, would it be taxed at ordinary or capital gains?

Mr. DOHAN. The sale of the inventory would be taxed at ordinary rates. We merely say that, in fairness, if there is a loss on the sale of the inventory, there should be an ordinary loss allowed.

To comment upon the proposed section 770 dealing with the taxation of so-called service partners, there is not time to discuss this in detail, but the effect of the provision set forth in H.R. 9662 is to fail to distinguish between a capital and a profits interest.

It is the opinion of our committee that the draftsmen have simply missed the problem. The effect of their effort is double taxation. It will also produce the taxation at ordinary rates of unrealized appreciation in assets in complete disregard of the fact that profit

may never be realized. If an asset is worth more than it cost today, he gets taxed on it. It may not be worth more than the cost when the asset is sold.

The service partner should be taxed in the manner provided by the advisory group report which merely defers the tax on that unrealized appreciation until it is realized. It does nothing more than that, and that is consistent with the policy of sections 731 and 732 of the present law relating to partnership distributions.

Finally, a comment with regard to income in respect of a decedent. Under present regulations, earnings which are withdrawn before death of a partner do not appear as such in the deceased partner's Federal estate tax return. They will appear in the form of cash in bank or as property purchased with these withdrawn earnings, or maybe he spent them and did not deplete other assets. Yet those withdrawals are recognized and taken into account when it comes to computing the deduction under present 691 (c).

The proposal of the advisory group was to incorporate this rule of the regulations into the statute, and H.R. 9662 purports to do so but fails to include this provision with regard to withdrawn earnings.

The committee believes this must have been an oversight and in the report which has been filed, it suggests appropriate statutory language to make the inclusion.

Finally, when earnings of a partner who dies are taxed to the estate or other successor in interest, they are taxed in full and they have no basis. However, if those earnings are not in fact withdrawn from the partnership, there will be distortions and a loss of basis, unless those earnings are treated as though they had been withdrawn and then taxed to the estate and then recontributed to the partnership.

The committee in its written report recommends appropriate statutory language to cover this problem. Otherwise there will be a loss of basis, and what is not income at all will be taxed as income.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Dohan.

(The prepared statement of Mr. Dohan follows:)

COMMENTS BY THE PHILADELPHIA BAR ASSOCIATION, COMMITTEE ON TAXATION, ON SUBCHAPTER K AMENDMENTS IN H.R. 9662, TRUST AND PARTNERSHIP INCOME TAX REVISION ACT OF 1960

The Committee on Taxation of the Philadelphia Bar Association submits herewith its comments and recommendations with respect to the amendments to subchapter K contained in H.R. 9662.

The proposed amendments of H.R. 9662 to subchapter K, which differ from those of the advisory group incorporated in H.R. 4460, require forthright, albeit blunt criticism. They need a major overhaul.

In some instances substantive changes masquerade as clarifications, yet far extend existing law. An example of this is section 770 of the bill, which taxes partners receiving a partnership interest for services. This principle is not open to criticism, but not content with incorporating present regulations into the code, the draftsmen have produced a section which can result in the new partner being taxed twice at ordinary income rates on certain portions of his partnership interest.

The exceptions engrafted on general rules reach such profusion as to emasculate the rules they modify. The new election for simplified reporting is a good example. This contains so many restrictions that it will be virtually useless to any partnership.

There are important omissions, which can only make the statute more difficult than it now is.

The alleged "loophole closing" provisions have apparently been drafted without any real knowledge of their revenue effect. Justification, if any, has been said to be the protection of respect for the revenue system by the small—and numerous—taxpayers. However, the draftsmen have failed to recognize that subchapter K primarily affects the *small* taxpayer, and that its provisions are already too complex. Further limitations, complicating provisions allegedly for the protection of the revenue, which must be considered by small and large taxpayers alike, not only lose the respect of the small taxpayer—from lack of understanding, but will lose the respect of the large taxpayer, and of advisers to both groups, by the incredible multiplication of one-sided revenue-protecting technicalities.

As a final general comment, a word should be said with regard to simplification. With each amendment to the code the statute becomes longer, more complex, and more difficult for all, including the expert, to understand. It is therefore essential that amendments not further complicate the law, but simplify wherever possible. The Philadelphia bar committee believes H.R. 9662 fails this test.

Throughout the comments which follow, reference will be made to the "Philadelphia bar committee." References to the advisory group report are to the revised report on partners and partnerships dated December 31, 1957.

DETERMINATION OF CHARACTER OF INCOME

Section 702(b), I.R.C. and H.R. 9662 (House report, pp. 21–22, 76–77)

Under present law only items specified in section 702(a) (1) to (8), inclusive, retain their original character in the hands of the partner as if realized directly by him from the same source. The advisory group recommended that this be expanded to include all partnership items, particularly those under section 701(a)(9), and H.R. 9662 so provides.

The bill attempts to cure an ambiguity in present law as to the level at which the character of an item is to be determined, e.g. partnership level or partner level, or stated differently, the entity or aggregate approach. The bill adopts the aggregate approach, although it adds a sentence which suggests that in determining the character of any item, "due regard" must be given to any business, financial operation, or venture of the partnership. The result is a determination on a partner-by-partner basis, with some partners being treated differently from others.

In conjunction with the collapsible corporation provisions in section 341(e) and with regulations such as section 1.1375–1(d), this proposal suggests a developing Treasury program to persuade Congress to enact still another complicating set of rules to an overburdened statute. Under those rules the activities of one or more taxpayers are attributed to others, somewhat like the maze of attribution of ownership rules of sections 267, 318, and 544.

The Philadelphia bar committee does not subscribe to this addition for several reasons. Primarily, the amount of revenue involved in this provision could not possibly be significant. Secondly, the partnership sections are already highly complex and this would make them much more so. Thirdly, the provision can only lead to administrative difficulties and to disregard by taxpayers through incomprehension.

This is shown clearly by example 3 on page 77 of the House report, where one partner is a member of several partnerships, none of which is in the real estate business. Each firm sells a piece of land independently of the other and this may be sufficient to result in the common partner being given ordinary income treatment with respect to his share of the proceeds of each sale. The parenthetical phrase in the first example will also lead to administrative difficulties, for there the activities of one partner, in conjunction with those of his partnership, may amount to his carrying on a trade or business. Factual determinations made by revenue agents under these examples will lead to unnecessary difficulties for everyone.

Actually, section 702(b) as proposed is an extension of the recommendations of the advisory group, which merely extended the section's application to section 702(a)(9). Even if the last sentence of section 702(b) as proposed in H.R. 9662 is deleted, the regulations promulgated by the Treasury may incorporate its meaning.

Accordingly, the Philadelphia bar committee, like the house of delegates of the American Bar Association in its most recent action (August 1959), recommends a return to the entity concept under which the character of the gain and loss on sale of property would be determined at the partnership level.

Under such a rule the activities of the partnership, and of any partners who act for it in connection with the particular sale, would be considered in determining the character of the income. The result would be identical treatment of all partners. Such a rule has the merit of simplicity.

ELECTION FOR SIMPLIFIED REPORTING

New section 702(c) (House report, pp. 23, 78)

This new section purports to aid the small partnership by permitting it an elective method of simplified reporting under which each partner will report his separate share of only *(a)* long term capital gains and losses, *(b)* short term capital gains and losses, *(c)* gains and losses from sales of section 1231(b) assets, *(d)* dividends, *(e)* the net ordinary income or loss and all other items. The price for these privileges includes denial of deductions or exclusions which under other code sections are limited to a fixed amount or percentage of income. The election is avilable only to partnerships all of whose partners are individuals.

In addition to loss of any deduction for charitable contributions, a partnership would lose the right to percentage depletion, soil and water conservation expenditures, and exploration expenditures. This effectively eliminates oil and gas partnerships, many ranching partnerships. Also unable to utilize the section are those partnerships with trusts, estates, or corporations as partners. Its scope is considerably hobbled as a result. But if a partnership does not have these unusual items, and is uncharitable, it will find the usual and familiar method of reporting perfectly simple. It can merely disregard the categories requiring separate classification. Although represented as increasing the "simplicity" of subchapter K, as a practical matter the proposal simply increases the number of provisions and poses a further puzzle for taxpayers and revenue agents. For the simple partnership the proposed amendment provides no help, but only traps. It has little hope of achieving its purpose.

The Philadelphia bar committee strongly recommends that it be deleted from the bill.

ORGANIZATIONAL EXPENDITURES

Section 703(b)

By adding a new subsection to section 703, H.R. 9662 follows the advisory group's recommendation to permit deduction of partnership organization expenditures. The provision does not, however, permit deduction of expenses of revising partnership agreements or of obtaining capital contributions. The deduction is limited to expenses which are chargeable to capital account. This section closely follows section 248 dealing with corporate organizational expenditures.

The intricacies of subchapter K make it important for partners to be able to rearrange their agreement in the light of admissions, deaths, withdrawals, the section 754 election, and changes in the law (including the substantial substantive changes made in H.R. 9662). The same comment is true as to expenses of drafting or amending a buy and sell agreement.

There will be considerable difficulty in segregating expenses attributable to the obtaining of capital contributions. The necessity for eliminating from the deduction the portion of the expense allocable to noncapital expenses and to transfers of the assets to the partnership will have like results. Such allocations are more readily made in the case of a corporation, but this is not reason to apply the same criteria to a different situation.

The Philadelphia bar committee does not consider the problem of rearranging partnerships analogous to that of reorganizing corporations, recommends the deletion of the proposed section 703(b)(3) and instead strongly favors adoption of the advisory group's proposal (p. 11 of advisory group report).

BASIS OF PARTNERSHIP INTEREST

Section 705, I.R.C.; H.R. 9662, sections 705, 763

Under present law the basis of a partner's partnership interest is established initially by reference to contributed property and thereafter is increased by his

distributable share of taxable and exempt income, and decreased (not below zero) by his share of losses and nondeductible expenditures. This general rule was difficult to apply, and for this reason a simpler alternative rule was provided, whereby the basis of the partnership interest was determined by reference to the partner's pro rata share of the adjusted basis for partnership properties. Under the regulations, the alternative rule could not be used unless it could be shown that there was no substantial difference in result. Accordingly a partner could not use the simple rule without first computing basis under the general rule.

This dilemma was removed by the advisory group, which not only reversed the rules, making the alternative rule the general rule and vice versa, but also required a comparison of the two rules only where the person, including the revenue agent, arguing that there was a substantial difference could establish that such a difference existed. This was not embodied in its legislative proposal, and the Philadelphia bar committee, in commenting on this section, recommended that the advisory group's proposed section 705(d)(2) be amended by adding at the end thereof the sentence: "The person seeking to establish such substantial difference shall have the affirmative burden of proof."

H.R. 9662 has followed the advisory group's report insofar as reversing the order of the two rules, but it has put the burden on the partner of proving that there is no substantial difference between the basis computed under the new general and the new alternative rule.

The result of this is to leave the law exactly where it is, with no improvement. As a legislative accomplishment, it has no merit.

The Philadelphia bar committee recommends adoption of the advisory group's recommendation with the additional sentence referred to above.

If new section 705 is to remain, the Philadelphia bar committee recommends deletion of section 705(b)(2)(D), which is the catchall phrase "other circumstances." There is no hint given in the committee report as to its meaning, and it appears unnecessary. The Philadelphia bar committee also recommends deletion of the last sentence of section 705(b)(2) which states that if adjustments are made under regulations to eliminate any substantial difference, then the new general rule can be employed.

Finally, the Philadelphia bar committee recommends that section 705(b)(2) be changed by deleting the requirement that the partner "establish to the satisfaction of the Secretary or his delegate" that there is no substantial difference. This quoted language goes far beyond mere burden of proof. In a factual situation of this kind, how can a partner satisfy a delegate who refuses to be satisfied? It is recommended that this subsection be amended to read as follows:

> "(2) the partner fails to establish by a preponderance of the evidence that there has been no——".

COLLAPSIBLE PARTNERSHIP RULES

Section 751, I.R.C.; H.R. 9662, sections 749, 750, 751

Where a partnership would realize ordinary income on sale of an asset, section 751 of present law preserves this result in the case of sales of partnership interests and of distributions of partnership property. The rules of this section have been criticized for their complexity, and to simplify them the advisory group made a number of recommendations which achieved this result without sacrificing either revenue or the basic concept. These included:

(1) making section 751 inapplicable to distributions unless by agreement of the parties its application is preserved (not included in bill);

(2) limiting use of the section to cases where the ordinary gain exceeds $1,000 (not included in bill);

(3) requiring that the section is not to apply unless there is an overall gain on the transaction, taking into consideration not only the portion of the proceeds attributable to section 751 assets, but also the portion attributable to all other assets (not included in bill);

(4) applying a single 15 percent substantial appreciation test to all section 751 assets, instead of only inventory assets, as is now the case (not included in bill):

(5) closing a loophole by requiring application of the 15-percent appreciation test to assets reduced by liabilities (not included in bill);

(6) inserting a new definition of "section 751 assets," which is closely related to the familiar capital gains definitions (included in bill);

(7) making section 1231(b) losses and offset to ordinary income realized on sale of section 751 assets (included in bill);

(8) assuming all property to have been held more than 6 months, thereby eliminating distinctions, fictional in these cases, between short- and long-term capital gains (included in bill);

(9) providing a rule that the character of income is to be determined at the partner level, giving "due regard" to partnership activities (included in bill); and

(10) providing a special basis for a transferee partner selling his interest within 2 years, comparable to present section 732(d) (included in bill).

While a majority of these proposals have been incorporated into sections 749, 750, and 751 of H.R. 9662, several have not, and it is to these omissions that the following comments are directed.

As to (1) the advisory group recommended that section 751(b) not apply to distributions. Its main reasons were that such a change would not appreciably affect revenues and would greatly simplify the partnership rules. To preserve the basic structure of the rules, and as an integral part of its recommendations on section 751, it proposed to amend section 735(a) so that distributed inventory would retain its character as such regardless of how long it was held, and it also foreclosed possible basis adjustments where a section 754 election was in effect. While this proposal would permit some shifting of income between partners, this is nevertheless possible to some extent under present section 704(c)(1). The possibilities of such shifts are slight and are outweighed by the importance of an understandable statute.

The draftsman of section 749 appear to have overlooked the significance of the advisory group's amendment to section 735(a) which effectively preserves the ordinary income character of distributed inventory. By a further amendment to section 735 this character is retained in the hands of any nonpurchasing transferee of a distributee partner. This adequately prevents the conversion of ordinary income into capital gain, and in the interests of simplicity the Philadelphia bar committee recommends that section 749 be deleted in conformity with the advisory group's proposal.

The advisory group proposal to eliminate the 5-year rule in section 735(a) was conditioned on excision of section 751(b). If the latter section is to be retained, then the 5-year rule should also be retained.

The second recommendation of the advisory group was to insert a "de minimis" rule, which has been omitted in H.R. 9662. Such a rule has been employed in sections 734(b) and 743(b), now sections 781 and 782, as a simplification measure. The same reason applies here even more cogently, and the Philadelphia bar committee strongly urges that the rule be inserted in sections 749 and 750 of the bill. This can be accomplished by adding to section 749 the following sentence: "This section shall not apply unless the gain attributable to section 751 assets exceeds $1,000.", and by adding to section 750(b) a new paragraph (4) as follows:

"(4) distributions where the gain attributable to section 751 assets is less than $1,000."

The advisory group's recommendation (3, supra, limits the scope of present section 751 by requiring that there be an overall gain on the transaction so as to invoke the most complex section of the subchapter only when the evil warranted. The reason for doing so was simplification. Section 749 as proposed does exactly the reverse. The House report (p. 28) states that the presence or absence of overall gain is immaterial insofar as taxing the ordinary income element of the sale is concerned. The Philadelphia bar committee believes that the advisory group's reason is an overriding consideration and recommends deletion of the last sentence of section 749 and substitution therefor of the following: "This section shall not apply if there is no gain on the sale or exchange of the partnership interest."

If this change is not made, appropriate language should be inserted in the statute to permit a partner who sells his interest to deduct as ordinary loss his share of the decline in value of section 751 assets. There is no such provision in present law, but if the partner is to pay tax on ordinary income, he should in fairness be allowed to deduct an ordinary loss.

By retaining the substantial appreciation tests of present law, contrary to recommendation (4), supra, the way is still open to avoid application of the collapsible partnership rules altogether and the loophole referred to in the advisory group's report at page 30 has not been closed. This can be accomplished by investing in property and borrowing a substantial portion of the purchase price.

The Philadelphia bar committee recommends adoption of the advisory group's single test for substantial appreciation in order to simplify the section and to close the loophole.

Unless these changes are made, section 741 becomes a mockery, for section 751 takes away all—and more—than section 741 gives.

The Philadelphia bar committee has a final comment. Recommendation (9), supra, of the advisory group's report proposed a rule whereby the character of income realized was to be determined at the partner level, thus following the conduit theory already discussed under section 702(b). For the reasons there stated, the Philadelphia bar committee recommends that section 751(c)(1) of H.R. 9662 be changed so as to provide that the character of the income is to be determined at the partnership level.

PARTNERSHIP INTEREST FOR SERVICES

New section; H.R. 9662, section 770

The Philadelphia bar committee agrees in principle that the rules of existing regulations should be incorporated into the code. It disagrees with the provisions of H.R. 9662 primarily with respect to the elimination of the advisory group's recommendation to limit the service partner's ordinary income to his share of the basis of partnership properties. In this connection the draftsmen of the new law appear to have largely missed the problems the advisory group report anticipated in its recommendation.

An example will help to point up the difference between the two proposals. Assume that at the time of 10 percent partnership interest is transferred without restriction to the service partner, his pro rata share of partnership assets is as follows:

	Basis	Fair market value
Cash	$10	$10
Inventory	10	15
Capital assets	10	20
	30	45

Under the advisory group's proposal, the service partner would be taxed on the lesser of the fair market value of his interest or his share of basis of partnership properties, or $30. When the inventory is thereafter sold for the indicated fair market value, he will realize $5 of ordinary income, and when the capital asset is similarly sold he will realize capital gain of $10. The partner(s) relinquishing the interest would have a deduction of $30 or would be entitled to increase the basis of partnership properties by the same amount.

On the other hand, under proposed section 770, the service partner realizes ordinary income of $45 at the time the partnership interest is transferred to him. He is thus being taxed currently on appreciation which has not yet become a reality (*and may never become such*). The basis of these assets in the partnership being unaffected by his acquisition of the interest, he will again be taxed on the appreciation when they are later sold. If treated as a purchaser, there would be an election possible by the firm under proposed section 782 (present sec. 754), but the service partner cannot control his partners in this regard. He would also be entitled to a basis step-up in the event of a distribution to him under new section 784 (present sec. 732(d)) or a sale of his interest under new section 785. But this may not be possible, and as a result there is a substantial probability of double taxation. If he is treated as a contributor of money, he could enter into an agreement with the other partners under section 704(c) which would result in the $5 ordinary income and $10 capital gain being allocated entirely to them.

The treatment provided in proposed section 770 leads to confusion between interests in capital and profits. As to the inventory in the above illustration, the other partners would be very likely to treat the $5 profit as a share of profits, yet the $5 is part of the capital interest under H.R. 9662. In the reverse situation the difficulties are more serious. Suppose that the service partner was given merely a 10 percent interest in future profits resulting from sale of the inventory and capital asset. Under section 770 this is in effect an interest in capital to the extent of the appreciation, and having received an interest in capital in exchange for services, he appears to have realized ordinary income under section 770, which would include the inventory appreciation and increase

in the value of the capital asset. In this latter instance capital gain would be converted into ordinary income.

The advisory group proposal has the merit of simplicity and of taxing income—and capital gain—when and to the extent realized, instead of on a basis inconsistent with economic realities. The possibilities of tax avoidance under such a rule are minimal and can be easily controlled by regulations. For these reasons the Philadelphia bar committee urges adoption of the advisory group proposal.

AMOUNTS PAID TO RETIRING PARTNER OR DECEASED PARTNER'S SUCCESSOR IN INTEREST

Section 736, I.R.C., H.R. 9662, section 776 (House report, pp. 34–36, 95, 96)

In general the Philadelphia bar committee approves of the amendments to present law by section 776 of H.R. 9662, but desires to comment on two of the changes.

First, the advisory group recommended that present law be changed to permit a partnership and the successor of a deceased pertner, for example, to reach an accord on partnership goodwill without having to include it in the partnership agreement. To require such an inclusion was considered unnecessary. Moreover, the proposal gave the parties a flexibility in their dealings with each other which enabled them to resolve a problem frequently overlooked until after the event. The Philadelphia bar committee believes that this latitude is desirable in view of the many tax implications flowing from the death or retirement of a partner, particularly since little or no tax avoidance is involved. Cf. Willis, Little and McDonald, "Problems on Death, Retirement, or Withdrawal of a Partner" 17th Ann. Inst. on Federal Taxation, New York University (1959).

Secondly, section 776(c) (3) provides that payments made under section 776(a) after termination of the partnership continue to be taxable to the recipient, and the payor may deduct such payments if, inter alia, he is operating a trade or business as a sole proprietor. The reason for this requirement, contained in section 776(c) (3) (B) (iv), is not explained in the committee report. The Philadelphia bar committee sees no reason to distinguish between a surviving partner who, while making payments, engages in a trade or business as a proprietor and one not so engaged. Furthermore, a successor partnership, a corporation or an estate could not deduct the payments under the proposed amendments. If a partnership incorporates and the corporation continues the payments to a deceased partner's successor, it will not be able to deduct the payments, even though they are to be made fully taxable to the recipient. The Philadelphia bar committee believes that the deduction should be allowable to the person making the payment and recommends that section 736(c) (3) of the advisory group's proposal (p. 34 of the revised report) be substituted for section 776(c) (3).

INCOME IN RESPECT OF A DECEDENT

Sections 691, 1014, I.R.C., H.R. 9662, sections 691(e), 777, 1014(c) (House report, pp. 36, 37, 99–101)

Under section 1.753–1(b) of present regulations the distributive share of income of a deceased partner for the period ending with death is income in respect of a decedent where the partnership year does not close until after his death. The example at the end of section 1.753–1 of the regulations and the advisory group report recognize that earnings withdrawn before death will be taken into account for purposes of determining the estate's deduction under section 691(c), even though the withdrawal will not appear as such in the deceased partner's estate tax return. Section 691(e) (1) of H.R. 9662 omits this point, and this rejection of the advisory group's recommendation, even if unintentional, may occasion a change of position in the regulations. Failure to make provision for this situation can result in the distributive share being subjected to income and estate taxes in excess of 100 percent of the income. For this reason the Philadelphia bar committee recommends that section 691(e) (1) be amended by adding the following sentence at the end thereof: "For purposes of subsections (a) (1) and (c) (2) (B) of this section the amount of such distributive share shall not be reduced by withdrawals made prior to such deceased partner's death."

A second comment of the amendments to these sections is needed. The distributive share of earnings for the period ending with the partner's death is taxable income to the successor in interest of the deceased partner, whether

or not distributed. Being taxable in this manner, the earnings should acquire a basis, for if they do not, distortions and inequities occur. For example, if the partnership agreement provides for payments under section 736(a) to the successor in interest of a deceased partner of $60,000 one year after death, and at the date of death undrawn earnings were $5,000, and if the estate tax value of the $60,000 payment to the successor is $56,400 (discounted at 6 percent), the basis of the partnership interest should be $61,400. The difference between the basis of $61,400 and the total payments of $65,000 represents the 6-percent discount, which is ordinary income. If this addition to basis is not permitted, $8,600 ($65,000—$56,400) will be taxed, instead of $3,600, the correct amount. Similarly, if the $5,000 had been invested in property, there would have to be an increase in the basis of the partnership interest.

To avoid these difficulties, the advisory group recommended that the basis of a partnership interest received from a deceased partner be its basis under section 1014(a), reduced by what it called "accruable items" and section 736(a) payments. The Philadelphia bar committee endorses this recommendation and to accommodate the recommendation within the framework of H.R. 9662 suggests that section 1014(c)(2) be amended to read as follows:

"(2) that portion of the value of an interest in a partnership attributable to property which constitutes a right to receive an item of income in respect of a decedent under section 691(e) (2) (3), and (4)."

ELECTION TO ADJUST BASIS

Section 754, I.R.C.,
H.R. 9662, section 780
(House report, pp. 37, 38, 96, 97)

The advisory group's proposal permitted the election to adjust basis of partnership properties to be revoked at any time within 3 years from the date of filing the partnership return. This period coincides with the normal statute of limitations, is analogous to the revocation privilege in section 901 I.R.C. (relating to foreign tax credit), and recognizes the fact that the significance of the election may not be realized until after the revenue agent has examined the return. The advisory group's proposal permitted revocation of either of the elections now contained in sections 781 and 782.

H.R. 9662 reduces this period to 1 year and permits revocation within 1 year as to either, but not both of the elections in sections 781 and 782. To provide flexibility and to simplify the law, as well as for the reasons referred to above, the Philadelphia bar committee recommends enactment of the advisory group's proposal.

The CHAIRMAN. The next witness is Mr. Paul E. Farrier of the U.S. Chamber of Commerce.

STATEMENT OF PAUL E. FARRIER, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. FARRIER. Mr. Chairman, and Senator Williams, I am Paul E. Farrier, vice president of the First National Bank of Chicago. I appear here today on behalf of the Chamber of Commerce of the United States and its committee on taxation.

In the larger statement filed with the committee, I have tried to point out some of the desirable features of H.R. 9662 as well as a few of the undesirable which should be either amended or eliminated. I ask that this statement as well as the statement of the chamber on subchapter K be made a part of the record.

The CHAIRMAN. The insertion will be made.

Mr. FARRIER. The statement on subchapter K would have been presented by Mr. Albert H. Cohen but for the limitations on time.

I shall use the present time in emphasizing one feature of the bill relating to subchapter J which should be eliminated entirely, and one amendment to the bill which we believe should be made. Now, this is

not to imply that these are the only problems involved, and I do hope that all the matters discussed in the statement will be acted upon.

I want to deal first with section 669 dealing with multiple trusts. This was explained by Mr. Craven who preceded me. We believe this section should be eliminated as unnecessary and undesirable.

I think you would agree that if there is a multiple-trust problem, and I emphasize the word "if," it must exist in the area of trusts that have income of $10,000 or less. Obviously, if one set out to use multiple trustee for tax avoidance purposes, one would see to it that each separate trust that was created had retained income of less than $10,000 simply because the rate of income tax in excess of this figure becomes very substantial and if tax avoidance is the purpose, then, of course, retained income is supposed to be taxed at lower rates.

Now, with this premise, I call your attention to the testimony of Mr. Johnson and Mr. Weston Vernon before the Ways and Means hearings on general tax revision. There these gentlemen pointed out that based upon the Treasury Department's latest statistics of income, all the accumulated income of trusts with taxable income of less than $10,000 amounted to less than 3 percent of the total income reported by trusts. Trusts reported $4 billion of income, and yet the retained income in these so-called possibility of tax avoidance cases only amounted to $170 million.

Senator WILLIAMS. May I ask a question at that point?

Mr. FARRIER. Yes.

Senator WILLIAMS. Do you have the breakdown further which would show the percentage with income of $20,000, $50,000, and so forth?

Mr. FARRIER. I do not believe it shows it in that breakdown. These are taken from the statistics of income of the Treasury Department and I do not believe they break it down below that or above that.

Senator WILLIAMS. We can get it from the Department.

Mr. FARRIER. If you can get it, I would like to see it, too.

Now, of course, the Government is already collecting income on this figure, whatever it is, and it is obviously a small figure and the question is just how much more income or revenue would be produced if you enacted section 609.

Naturally, not all trusts in this area are multiple trusts. They include single trusts where income is accumulated for minor children and many other trust purposes. They also include trusts where some part of the income is added to principal on account of amortization of bond premiums or other accounting provisions under the principal and income laws of various states.

In fact, based upon a survey of trusts administered by my institution, the First National Bank of Chicago, one of the largest in the country, less than 1 percent of the total income could under any stretch of the imagination be attributed to what might be called multiple trusts.

On this basis substantially less than $2 million, and that is million, not billion, of income is involved in the entire United States.

Considering the fact that such income is already taxed at the low rates of tax, the actual increase in revenue through the enactment of section 669, I do not believe could possibly equal a half-million dollars. This, of course, is not net, since increased cost of compliance by the

taxpayer reduces other taxable income and increased costs of administration reduce the net to the Government.

On balance it seems doubtful to me that any net revenue to the Government is involved. Now, no one will question but what there are a few isolated cases in which multiple trusts have been created for tax avoidance purposes. Also, no one would question that a provisions such as section 669 will severely penalize many trusts which were created for perfectly legitimate trust purposes with no thought of tax avoidance.

If you would like to look at a couple of examples, I call your attention to those on pages 15, 16, and 17 of the prepared statement. Perhaps I might even take your time to give you a good example of a perfectly legitimate trust situation that is going to be penalized by section 669.

Suppose I have two children, one of whom is a perfectly normal, fine boy. The other child perhaps is mentally retarded. I want to treat my children equally, so I create two trusts, one for each child. So far no multiple trust problem at all.

I provide as to the normal child that he shall have his principal at age 25, and he lives to age 25, gets his principal, goes his way and still no multiple trust problem.

The second child does not get his principal at all because he never is going to be able to take care of it, and so I provide that upon his death, it shall go to his children if he has any; if he doesn't have any, it goes to his brother. This is a perfectly normal trust distribution.

He lives to be age 55, dies without any children, and his trust becomes distributable to his brother, this is 30 years after the brother's trust had been distributed. Under those circumstances, section 669 applies and we have a multiple trust situation with all of its complications and all of its penalties.

To draft into an already complicated statute a provision as complex as this section in order to still someone's sporadic concern over what to me is an almost nonexistent problem would be an unfortunate solution.

Finally, it may be recalled that for many years the deduction for personal exemption granted to a trust was equal to that granted a single person. The decision to make the deduction for personal exemption for a trust less than that of an individual taxpayer was based, at least in part, upon the premise that the adoption of such a measure would be a solution to the multiple trust arrangement, and I think it has been a solution because they just are not being created in any volume.

This solution is adequate in itself. However, should it be determined that some other legislative means should be adopted for this purpose, then there is no question in my mind but what the deduction for personal exemption granted to trusts should be restored to equality with the deduction granted an individual.

I should also like to call to your attention section 669(a)(3) which provides that the character of income rule does not apply to multiple-trust distributions. Now, this means that interest on municipal bonds will become taxable income when a part of a multiple-trust distribution. I just cannot conceive that Congress means to approach this municipal bond interest problem in such an indirect manner.

There is another important principle involved. Since the beginning of the income tax law, it has been recognized that trusts were merely conduits of income and were not entities in themselves.

This denial of the character of income seems to me to be a reversal of that principle.

Now, I come to the section which I would like to see amended—I think section 669 ought to be eliminated entirely—section 663(a) (2) ought to be amended.

In brief, the section as drafted is so narrow in its scope that the solution to a troublesome estate problem is entirely overlooked. In effect, under present law, any distribution of a decedent's estate is treated as a distribution of taxable income to the extent that the estate had taxable income.

Mr. Craven also touched on this concept in his presentation. The result in many cases is to treat as taxable income the household furniture which is distributed to a widow on the death of her husband. This, of course, is a horrible example, and the proposed section 663(a) (2) does correct this particular horrible example.

However, there are other horrible examples which are in no way alleviated. For example, A's estate consists of listed securities, cash, and stock in the family business. His will leaves his entire estate to his son. Now, it might be vital to the business that the stock in the family business be distributed to the son at the earliest possible moment, because, after all, an executor's powers of voting stock are somewhat limited. The executor may be perfectly willing to distribute the stock in the family corporation to the son, but would be unwilling to make any other distribution from the estate until the debts and taxes on the estate are paid. He has a liability for those. Yet, if the executor distributes the stock in the family business to the son, that stock in the family business will be taxed as income to the son under the provisions of the proposed section 663(a) (2).

Let us take another horrible example of the inequitable results of the proposed section. Let us take one estate which consists entirely of real estate. It is very fine real estate, and perfectly salable. It is the finest real estate in town.

A second estate consists entirely of securities; they are also readily salable. There is very little difference between the two except one estate is real estate and the other estate is securities. A distribution by the one estate of all the real estate has no tax consequences to the distributee at all under this proposed section. However, under this proposed section, the distribution of any of the securities in the second estate would result in taxable income to the distributee. I cannot believe this is equity and fairness.

A third example will illustrate another type of problem created by the proposed section. Let us suppose that A's will provides that his property shall go to a trustee, to pay the income to his wife for life and upon her death to be distributed to the children. Now, the executor desires to partially fund that trust so that A's widow would begin to get income. Therefore, the executor transfers securities in the estate to the trustee as a partial distribution; this is perfectly normal estate administration.

Under State law, of course, these securities belong to the corpus of the estate, to be held for the widow with income for life and

remainder to children. The widow, of course, will receive the income from the securities, when collected. There is no problem about that.

However, under the proposed section, the trustee would be deemed to have received taxable income by reason of its receipt of the securities and would have to pay a tax thereon.

This, of course, goes to reduce the distributive share of the children who never received any income. This seems, to me, an obvious inequity.

Now, the very least that ought to be done to correct this particular section is to amend section 663(a)(2) by eliminating the word "tangible" in the first sentence thereof. That is all that is necessary.

Thank you very much.

The CHAIRMAN. Any questions?

Thank you, Mr. Farrier.

(The prepared statement submitted by Mr. Farrier follows:)

SUMMARY OF TESTIMONY BY PAUL E. FARRIER IN SUPPORT OF H.R. 9662

I am Paul E. Farrier, vice president, trust department, the First National Bank of Chicago. I appear here today on behalf of the Chamber of Commerce of the United States as a member of its committee on taxation.

In a larger statement filed with the committee, I have tried to point out some of the desirable features of H.R. 9662, as well as a few of the undesirable ones which should be amended or eliminated. I shall use the present time in emphasizing one feature of the bill which should be eliminated and one amendment to the bill which should be made. This is not to imply that these are the only problems involved, and I earnestly hope that all of the matters discussed in the statement filed will be acted upon.

SECTION 669 SHOULD BE ELIMINATED

Section 669, dealing with multiple trusts, should be eliminated. It is unnecessary and undesirable. I believe you would agree that if a multiple-trust problem exists it would be in the area of trusts with retained income of $10,000 or less. Obviously, if one set out to use multiple trusts for tax-avoidance purposes one would see to it that each separate trust had retained income of less than $10,000 simply because the rate of tax on income in excess of this figure becomes very substantial and the tax-avoidance purpose, if it exists, is to have the retained income taxed at lower rates of tax.

With this premise, may I call your attention to the testimony of Messrs. James P. Johnson and Weston Vernon, Jr., before the House Committee on Ways and Means hearings on general tax revision. There, these gentlemen pointed out that, based upon the Treasury Department's latest statistics of income, all the accumulated income of trusts with taxable income of less than $10,000 amounted to less than 3 percent of the total income reported by trusts. (Total trust income, $4 billion; total retained income of all trusts having taxable income of less than $10,000, $117,553,000. See p. 1759 of committee print.)

Of course, the Government is already collecting income tax on this $117.5 million and the question is how much more revenue would be produced if the so-called multiple trusts in this group were made subject to the proposed section 669. Naturally, they are not all multiple trusts. They include single trusts where income is accumulated for minor children and other trust purposes. They also include trusts where some part of the income is added to principal on account of amortization of bond premiums and other accounting provisions under the principal and income laws of the various States. In fact, based upon a preliminary survey of trusts administered by the First National Bank of Chicago, less than 1 percent of the total income could, by any stretch of the imagination, be attributed to so-called multiple trusts. On this basis, substantially less than $2 million of income is involved in the entire United States. Considering the fact that such income is already taxed at lower rates of tax, the actual increase in gross revenue, through the enactment of section 669, cannot equal a half million dollars. This, of course, is not net, since increased costs of compliance by the taxpayer reduce other taxable incomes and the increased costs of administration directly reduce the net return to the Government. On balance, it seems doubtful if any net revenue to the Government is involved.

No one will question that there are a few isolated cases in which multiple trusts have been created for tax-avoidance purposes. Also, no one will question that a provision such as section 669 will severely penalize many trusts which were created for legitimate trust purposes, with no thought of tax avoidance. To graft into an already complicated statute a provision as complex as this section in order to still someone's sporadic concern over an almost nonexistent problem would be an unfortunate solution.

Finally, it will be recalled that for many years the deduction for personal exemption granted to a trust was equal to that granted to a single person. The decision to make the deduction for personal exemption for a trust less than that of an individual taxpayer was based upon the premise that the adoption of such a measure would be a solution to the multiple-trust arrangement—and it has been a solution. This solution is adequate in itself. However, if it should be determined that some other legislative means is to be adopted for this purpose, there is no question but that the deduction for personal exemption granted to a trust should be restored to equality with the deduction granted an individual taxpayer.

I also call your attention to section 669(a)(3), which provides that the character-of-income rule does not apply to multiple-trust distributions. This measure means that interest on municipal bonds will become taxable income when part of a multiple-trust distribution. I cannot conceive that Congress means to approach this problem in such an indirect manner. Another important principle is involved. Since the beginning of the income tax law, it has been recognized that trusts were merely conduits of income and were not entities like corporations. This denial of the character of income seems to be a reversal of that principle.

SECTION 663(a)(2) SHOULD BE AMENDED

This section, as drafted, is so narrow in its scope that the solution to a troublesome estate problem is entirely overlooked.

In effect, under present law, any distribution from a decedent's estate is treated as a distribution of taxable income to the extent that the estate had taxable income. The result in many cases is to treat as taxable income the household furniture which is distributed to a widow on the death of her husband. This, of course, is the horrible example, and the proposed section 663(a)(2) does correct this particular horrible example. However, there are other horrible examples which are in no way alleviated.

For example: A's estate consists of listed securities, cash, and stock in a family business. His will leaves his entire estate to his son. It may be vital to the business that the stock in the family business be distributed to the son at the earliest possible moment. The executor may be willing to distribute such stock to the son, but unwilling to make any other distribution from the estate until the debts and taxes on the estate are paid. Yet, if the executor does so, the stock in the family business will be taxed as income to the son under the proposed section 663(a)(2).

Another horrible example of the inequitable results under the proposed section 663(a)(2) is as follows:

> One estate consists entirely of real estate; office buildings, apartments, and other readily salable real estate.
>
> A second estate consists entirely of securities which also are readily salable.
>
> A distribution of all of the real estate in the first estate has no income tax consequences to the distributee. However, under the proposed section 663(a)(2), a distribution of any of the securities in the second estate will be taxable income to the distributee to the extent that the estate has taxable income. Is this equity and fairness?

A third example will illustrate another type problem created by the proposed section 663(a)(2).

> A's will provides that his property shall go to a trustee to pay the income to his wife for her lifetime and on her death shall be distributed to his children. The executor desires to partially fund the trust immediately so that A's widow can be provided with income. Therefore, the executor transfers securities in the estate to the trustee as a partial distribution. Under State law, these securities belong to the corpus of the trust to be hled for distribution to the children on the death of the widow. The widow, of course, receives the income from such securities, which is subsequently col-

lected by the trustee and is taxable with such income. However, under the proposed section 663(a)(2), the trustee will be deemed to have received taxable income by reason of its receipt of the securities and will have to pay a tax thereon. This will reduce the distributive share of the children who never received any income. This is an obvious inequity.

The very least that can be done to correct these inequities is to amend the proposed section 663(a)(2) by eliminating the word "tangible" in the first sentence thereof. This is earnestly recommended.

Testimony of Paul E. Farrier for the Chamber of Commerce of the United States on H.R. 9662

I am Paul E. Farrier, vice president in the trust department of the First National Bank of Chicago. For 25 years I have been dealing daily with the tax problems of estates and trusts administered by the First National Bank of Chicago. However, this statement is presented for the Chamber of Commerce of the United States in connection with proposed revisions in subchapter J of the Internal Revenue Code as embodied in H.R. 9662.

H.R. 9662 COMMENDABLE IN MANY AREAS

H.R. 9662 is a commendable step toward the solution of many inequities in the taxation of estates and trusts. Among the amendments proposed therein which solve serious problems and deserve speedy approval by Congress are the following:

1. *Section 642(a)(3)*.—This amendment clears up the confusion concerning the treatment of the $50 dividend exclusion as it relates to estates or trusts which distribute only a part of the dividends received during a taxable year.

2. *Sections 642(c), 643, and other conforming amendments*.—This series of amendments would treat charitable distributions by trusts and estates as deductions from distributable net income under section 661 rather than as deductions from gross income under section 642. It is contemplated that these amendments will avoid certain complicating problems existing in the present code, will achieve less artificial results and will simplify estate and trust administration.

However, I would call to your attention that a change is required in section 643(a)(3)(A) in order to avoid what would otherwise be a hardship in the law. Since capital gains which are "permanently set aside or to be used for purposes specified in section 661(a)(4)" are to be included in the computation of distributable net income, capital losses "taken into account in determining the amount" of such gains should be excluded from the computation. This situation could be corrected by amending the second sentence of section 643(a)(3)(A) to read as follows:

"Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary, or which are permanently set aside or to be used for purposes specified in section 661(a)(4), during the taxable year."

3. *Section 642(h)*.—This amendment is designed to extend the deduction carryover to beneficiaries upon the termination of a single beneficiary's interest in an estate or trust having different beneficiaries. This is a necessary extension of the separate-share rule.

4. *Section 643(a)(3)(B)*.—This amendment would incorporate in the statute a set of rules for determining whether a distribution of corpus will require capital gains to be included in determining the distributable net income of a trust in a taxable year. These rules are modeled after those presently contained in regulation section 1, 643(a)-3.

5. *Section 643(a)(3)(C)*.—Under existing law, deductions which are properly allocable to the principal account of a trust rather than to the income account nevertheless reduce distributable net income, so that the benefit of the deductions is shifted to the income beneficiaries. This goes far beyond the declared objective of the law, which was to prevent the wastage of deductions. To the extent of income allocable to corpus, the proposed amendment would treat as corpus deductions all deductions which are charged to corpus under the governing instrument and local law, or which are charged to corpus in the discretion of the fiduciary.

I call to your attention, however, what appears to be a technical error in draftsmanship in section 643(a)(3)(C)(ii) of H.R. 9662. Consider the following example:

> During the taxable year, the trustee of a simple trust collects $5,000 of ordinary income and $500 of short-term capital gains. The trust also incurs an expenditure of $1,000 which is properly allocable to corpus under local law.

The report of the House Committee on Ways and Means indicates that, under this proposed section, $200 of the corpus deduction would be excluded from the computation of distributable net income. However, because of the language of section 643(a)(3)(C)(ii) which requires the trustee to take into consideration the deduction for distributions under section 643(a)(1) in determining to what extent corpus items of deduction are excludable under section 643(a)(3)(C), it appears that the proposed statutory language does not carry out the intent of the House as expressed in its committee's report. It would follow that, under this example, no portion of the corpus deduction would accrue to the benefit of the remainderman.

I believe that this technical error could be corrected by revising section 643(a)(3)(C)(ii) to read as follows:

> "(ii) The deductions which (without regard to this subparagraph or section 643(a)(1)) are excluded in computing distributable net income."

6. *Sections 652(c)(2) and 662(c)(2).*—This amendment makes clear the amount of income of a trust which is required to be included in the gross income of a beneficiary if the taxable year of the beneficiary terminates during the taxable year of a trust because of death or other reasons.

7. *Section 663(c).*—This amendment would extend the separate-share rule to estates and thereby allow a more reasonable allocation of income tax consequences in cases where several beneficiaries of an estate receive distributions of income and/or principal in varying amounts.

In addition to the foregoing, there are other technical changes which represent improvements in the law relating to the taxation of estates and trusts.

There are, however, some serious omissions, particularly with respect to the so-called throwback rule.

ADDITIONAL NEEDED AMENDMENTS TO THROWBACK RULE

It is suggested that H.R. 9662 be amended to provide for the repeal of subpart D of part 1 of subchapter J, the so-called throwback rule. Few sections in the code attain the degree of complexity and intricacy that one finds in the maze known as the throwback rule. In addition to the difficulty which even the skilled practitioner faces in attempting to apply the throwback rule, there is little question but that this rule has been and, in its proposed amended form, would continue to be inequitable since it fails to make special provision for many situations which ought not properly be within its ambit. Taking into consideration the purpose of subpart D, its present form, its proposed form under H.R. 9662, the awkwardness of its application, and the puzzlement which it causes to fiduciaries and individual taxpayers alike, I cannot exaggerate the undesirability of the throwback rule. In this connection, I would endorse the statement of Mr. George Craven appended to the final report of the House Committee on Ways and Means Advisory Group on Subchapter J, in which it is pointed out that:

1. It is doubtful if the throwback rule is effective in preventing a loss in revenue.
2. It is doubtful if any large amount of revenue is lost in this area.
3. The throwback rule is understood by only a small percentage of fiduciaries throughout the country.
4. It is doubtful if the throwback rule is susceptible of proper administration.
5. Few revenue agents can apply the throwback rule properly and, although personnel could be trained, their time could be spent more profitably in other areas of the income tax law.
6. Tax specialists can devise instruments which will largely avoid the application of the throwback rule with the result the rule will not apply to new large trusts but will apply only to small trusts prepared without the guidance of experts in the field.

In the event that subpart D is not repealed, it is recommended that, in order to relieve some of the administrative hardships caused by the subpart, the following changes be made:

A. The definition of "accumulation distribution," in section 665(b), should be altered so that the throwback rule will not apply to any prior taxable year unless the undistributed net income, as defined in section 665(a), for such year equals or exceeds a stated minimum amount. Under the present and proposed language of section 665(b), the throwback rule may be applied to a prior taxable year, even if the undistributed net income of such year is only $1. At the present time, the extent of undistributed net income of a prior taxable year is not considered in determining whether or not the throwback rule applies. Unfortunately, this often necessitates lengthy accounting computations by the trustee, difficult tax computations on the part of the taxpayer, and a cost of processing to the Government which is out of all proportion to the amount involved.

B. At the present time, the throwback rule becomes operative in those taxable years in which an accumulation distribution exceeds $2,000. Even if this accumulation distribution is made up entirely of undistributed net income of the trust for prior taxable years, no substantial increase in revenue results through the application of the throwback rule. Any gain in gross revenue that might result is inconsequential when compared to the additional cost to the Government in processing such returns. Therefore, it is advocated that the $2,000 amount mentioned in section 665(b) be increased to, at least, $5,000. It is my understanding that the majority of the Subchapter J Advisory Group supported such a change.

C. Section 665(b) should be amended to provide that the throwback rule will not apply in situations in which a trustee fails to make an immediate distribution of income because of a bona fide dispute or doubt as to who is entitled to such income or as to whether such amount is income or principal. In its final report, the Subchapter J Advisory Group recognized the need for legislation in this area and, although the problem is not exclusively a throwback problem, it appears that it would not be inappropriate to provide a solution to the problem in H.R. 9662.

Section 665(b)(3) provides that, under certain circumstances, undistributed net income of prior taxable years will not be subject to the throwback rule. This exception fits in rather well with the ordinary distribution arrangements for which a testator or donor of a trust would provide.

It is often desired that the assets of a trust be distributed over a period of time so that a beneficiary will not receive a large sum of money in a lump sum. This plan of distribution is common and is availed of without any thought of tax consequences. However, section 665(b)(3) is applicable only if such periodic distributions were required as of January 1, 1954. The throwback rule was not, nor should it be, designed to effect a change in what is recognized to be ordinary and customary trust distribution practice. Section 665(b)(3) should be amended to delete the January 1, 1954, requirement,

D. It is recognized that section 665(b)(5) would partially solve this inequity—but only if the amount is paid to the beneficiary as a final distribution of the trust, and then only if the trust was created by a will or was revocable by the grantor immediately before his death. These limitations to the operation of this exception to the throwback rule are, in my judgment, not realistic. There is no direct correlation between the desire to avoid the throwback rule and the creation of an irrevocable trust, just, as I have pointed out, as there is no correlation between a desire to avoid the throwback rule and a provision for the distribution of corpus to a beneficiary upon his attaining certain ages. What difference is there between a revocable trust that provides that, after the death of the donor, income is to be accumulated until a beneficiary attains age 30 and an irrevocable trust that has a similar provision? The two trusts may be exactly the same otherwise; i.e., the income of both can be taxable to the grantor during his lifetime, both could be exempt from gift tax upon creation, and both could be includible in the grantor's estate for Federal estate-tax purposes. What basis is there for drawing a distinction between the two by purposes of the application of the throwback rule?

E. Section 665(b)(6) should be amended to eliminate the requirements that, in order for the exception to operate, a distribution must not be related to the occurence of an event which causes the distributing trust to terminate. Consider the following example:

Under A's will, upon the death of his wife, trust corpus is to be divided into separate trusts, one for each of A's named children.

In such a situation, the exception under section 665(b)(6) would not be available and the throwback rule would apply. On the other hand, if a skilled drafts-

man provided that separate trusts should be "peeled off" for A's three oldest children and that the original trust should continue for A's youngest child, the throwback rule would not apply because the distributing trust would not terminate. There ought not to be different tax consequences in these two situations. Attorneys should not be required to distort dispositive language in order to satisfy an artificial distinction created by the proposed staututory language.

In addition, it is suggested that somewhere in section 665(b)(6) or 665(e) it be provided that, for purposes of applying section 665(b)(4), the trust to which a distribution is made will be deemed to have been created at the same time that the distributing trust was created and that the distributed propery will not be deemed to be a transfer.

F. Under section 666(a), the throwback rule may apply to each of the 5 taxable years preceding the current taxable year. This fact compounds the difficulties raised by subpart D and imposes on the trustee and taxpayer the responsibility of creating and maintaining extensive bookkeeping systems. The difficulty of maintaining these records increases with every additional year that has to be considered in a throwback computation. In order to ease this burden, which falls not only on the taxpayer and trustee, but also on the Government, the period of the throwback rule should be limited to 2 years.

There are three additional areas covered by H.R. 9662 which are open to serious objection.

THE FOUR-TIER SYSTEM

While it is realized that some provision should be made in the law to assure an equitable apportionment of taxable income among several beneficiaries, it is suggested that a system more understandable than the four-tier system be adopted. The proposed amendments to sections 661 and 662 establish the so-called four-tier system, which, despite its logic, so complicates the tax law that only an expert can predict the results. Despite 25 years of experience in this field, I am not enough of an expert to explain this proposal to beneficiaries who have difficulty understanding the tax consequences imposed upon them. It is especially difficult to convince a beneficiary who can never receive any income of a trust that he is to be subjected to income tax on the principal distributions which he receives.

There is also a possible ambiguity in the language establishing the four tiers. For example:

Under a testamentary trust, B is entitled to so much of the net income as the trustee, in his sole discretion, deems necessary for B's care and support. The trustee is also given discretion to pay parts of corpus to B if such payment are necesary for B's medical attention.

Is B a tier 1 or a tier 2 beneficiary? From the language of proposed statute, this might be answered in two ways:

First approach: In order to determine whether B falls in tier 1 or tier 2, it is necessary to examine the factual situation in the particular taxable year. If B did not need corpus payments because he incurred no medical expenses, he is a tier 1 beneficiary. On the other hand. if he did incur medical expenses and the trustee could, in that year, have paid portions of corpus to him, B is a tier 2 beneficiary.

If this approach is intended, B may be in a certain tier in some years and in another tier in other years. This might be called an escalator system rather than a tier system and might cause trustees serious problems in determining from year to year in which tier a beneficiary falls. In addition, this escalator system might enable the trustee to activate a tax-avoidance plan. For example:

Under a testamentary trust, a trustee has discretion to pay income to C or D for their respective care, comfort, and support. In addition, to the extent that income is insufficient, the trustee may pay portions of corpus to C or D for the same purposes. C is in a 90-percent income tax bracket; D is in a 20-percent income tax bracket.

If the escalator system is correct, and one must look at the actual circumstances in order to determine into what tier a beneficiary falls in a given year, the trustee could, on January 1, 1963, determine that C required a payment of $5,000 from principal. Notice that, as of this date, there is no income in the trust and that, since the $5,000 is sufficient to provide for C for the entire year, the trustee would not, for that year, have discretion to pay income to C. During 1963 the trustee pays D an aggregate of $5,000 from the net income of the trust. Distributable net income of the trust for 1963 is $5,000. Notice that

since D required no principal during 1963, the trustee, for that year, would not have discretion to pay principal to him. Therefore, D, who is in a 20-percent bracket, will receive all of the taxable income while the distribution to C, who is in a 90-percent bracket, will pass to him tax free. This result depends upon the manner in which the trustee elects to make payments and may permit the trustee to force the presence or absence of discretion for a particular year. In a succeeding year, if the income tax brackets of C and D were reversed, the trustee could pay income to C and principal to D and, again, participate in a tax-avoidance arrangement. Is it intended that such a loophole be available to taxpayers?

Second approach. Going back to the original example, B would be a tier 2 beneficiary since, under the governing instrument, there may conceivably be a set of circumstances in which the trustee could pay principal to him. Therefore, no matter whether the discretion is available in a particular year, B will always be on the same tier. In the example concerning C and D, which I have just mentioned in my analysis of the first approach, no matter how the trustee exercised his discretion, C and D would both be in tier 2 under the second approach.

If this is the proper interpretation, I believe there still remains a difficulty. It is not at all unusual for trust instruments to contain a so-called facility-of-payment clause. Such a clause grants discretion to the trustee to withhold amounts of income or principal which are otherwise required to be paid to a beneficiary if the beneficiary is under a legal disability. If the reasoning underlying this second approach is applied, net income may not be required to be distributed currently to any beneficiary of a trust which contains a facility-of-payment clause. Consider the following example:

Under a testamentary trust, the trustee is directed to pay to E one-half of the net income. The trustee, in his discretion, may pay the balance of net income to G or H. The trustee, in his discretion, may pay corpus to E, G, or H for their respective care, comfort, and support. The governing instrument contains a facility-of-payment clause. During 1963, trust income is $5,000. The trustee pays $2,500 to E from income, $2,500 to G from income, and $2,500 to H from corpus.

If the second approach is carried through to its logical conclusion, E, G, and H will all be tier 2 beneficiaries and the whole complicated tier arrangement will have become meaningless.

Tax-avoidance schemes are, of course, a problem, but surely something less complicated than this four-tier system is possible. Perhaps some tax avoidance might even be tolerated in the interest of understandability and simplicity. This is not a question of allowing income to escape taxation, but simply a question of allocating the taxable income among various individual taxpayers. It is urged that this problem be reconsidered and a more practical approach be adopted.

Assignment of charitable beneficiaries to the fourth tier

Another objection is the arbitrary decision to assign a charitable beneficiary to the fourth tier. The result is going to be to tax some individuals with a receipt of capital. Conceivably, this could be unconstitutional. A simple illustration will make this clear. Assume a trust created by will under which the trustee is required to pay all the income of the trust to a designated charity. In addition, the trustee has discretion to distribute some of the principal of the trust to A should A become ill and need help. In one year, $5,000, which is the entire income, is distributed to the charity as required and, in addition, the trustee pays A's hospital bill of $1,000 out of the principal of the trust. Under the proposal contained in H.R. 9662, A will be required to pay income tax on the entire $1,000 principal distribution. If the will had provided that all of the income were to be distributed to an individual, B, the result would be entirely different. Under such circumstances, A would not be taxed with any part of the $1,000 principal distribution. Why should A's tax burden be affected by the fact that income is paid to a charity rather than an individual? This arbitrary treatment of charitable distributions is neither necessary nor advisable and it is urged that, even if the four-tier system is adopted, charitable beneficiaries who receive income be treated exactly as other recipients of income.

SPECIAL RULES

Section 108 of H.R. 9662 would revise the provisions of section 663 of the code. The following recommendations are hereby made:

1. Section 663(a)(1), which prevents certain gifts, bequests, and distributions from being taxable to the distributees, should not be limited in its application to testamentary and revocable trusts. What justification is there for distinguishing, for purposes of this section, between a trust which is revocable prior to the death of the grantor and a trust which is irrevocable particularly if the grantor did not make a taxable gift at the time the trust was created? If an instrument provides that F is to receive $5,000 from principal in 1968, the treatment afforded by section 663(a)(1) should be available whether the trust was created under a will or was revocable or irrevocable by the grantor at the date of his death.

2. Section 663(a)(1)(A) should also be expanded in its scope. This section originally came up for consideration in the House on the recommendation of the Advisory Group on Subchapter J. The advisory group felt that section 663, under present law, is too restricted and it recommended that its provisions be liberalized. Now we find that there are certain cases which would be entitled to section 663 treatment under present law as to which such treatment would be denied if section 108 of H.R. 9662 is enacted. For example, a testator provides that $10,000 is to be paid to his grandson from corpus, $5,000 when he attains the age of 25. These payments should be entitled to section 663 treatment, and H.R. 9662 should be amended to so provide.

3. Section 663(a)(2) is designed to solve an existing inequity which taxes principal distributions as income. It should apply to all property, real or personal, owned by a decedent at the time of his death. It is often necessary or desirable to make an early distribution of intangible personal property to a residuary beneficiary. For example, it might become necessary to distribute stock of a closely held corporation to a residuary beneficiary shortly after the death of a decedent in order to facilitate the administration of the business. The value of this stock should not be deemed to be taxable income to the distributee. This is not a tax-avoidance device and should not be treated as one.

4. Section 663(a)(2) should also be altered to make it clear that amounts paid from corpus in satisfaction of a widow's award, and similar items, should not be deemed to be taxable income. It appears that the draftsmen of this section of H.R. 9662 had this problem in mind since the words "award" and "allowance" are used. However, because of the prior language of the section, unless the award is paid in real estate or in an automobile or a chest of drawers or other tangible personal property, section 663 treatment will not be available and the award will be subject to income tax.

5. Section 663 should be changed so that there will not be three different rules applied simultaneously to similar trust and estate situations. Under the section, as proposed in section 108 of H.R. 9662, there will be:

(*a*) One rule applying to estates, testamentary trusts, and revocable trusts which, essentially, come into existence after the enactment of the statute;

(*b*) a second rule applying to all other types of trusts coming into existence after the enactment of the statute; and

(*c*) a third rule applying to estates and irrevocable trusts which are in existence prior to the enactment of the statute. In this connection, I assume that the second sentence of section 108(a)(2) of H.R. 9662 contains a technical defect in that it does not make reference to "estates" which are in existence as of the enactment of the statute.

6. Finally, it is recommended that the framework of section 663, as contained in H.R. 9662, be abandoned and that there be adopted instead the approach of the Advisory Group on Subchapter J as contained in its final report to the House Ways and Means Committee.

MULTIPLE TRUSTS

Section 113 of H.R. 9662 proposes, among other things to add a new section 669 to the Internal Revenue Code.

The possibility that a person may create a series of similar trusts for a particular individual has for a long time intrigued authors in the tax area. These authors point out that, in theory, this is a convenient tax-saving device. These articles and the apparent simplicity of the device have magnified the problem out of all proportion. In fact, if one looks at the practical aspects of the situation, it is clear that the so-called multiple-trust device is not a problem at all.

Based upon a survey of representative corporate fiduciaries, it can be stated that there are very few multiple-trust arrangements in existence. The reasons

of this are obvious. Multiple trusts are not economical. The cost of administering small trusts makes their use prohibitive to the average taxpayer. Corporate fiduciaries have found trusts of less than $100,000 to be unprofitable and, therefore, they discourage their use. These are the reasons for the unpopularity of multiple trusts and illustrate the basis for the statement that they do not constitute a real problem. To make a parody on an old adage, "Everyone talks about multiple trusts, but very few people create them."

No one will question that there are a few isolated cases in which multiple trusts have been created. However, to graft onto an already complicated statute a provision as complex as proposed section 669 in order to still someone's concern over an almost nonexistent problem would be an unfortunate solution.

One would suppose that the prime objective of provisions to be contained in the Internal Revenue Code would be to raise revenue. There are no facts made public which in any way suggest that proposed section 641(c) will raise revenue. In fact, a contrary result is almost certain to occur. In order to police a statute of this sort effectively, the Government would have to employ additional help, create a new filing system and set up all sorts of safeguards to prevent a violation of the statute. In addition, trustees, particularly corporate trustees, would be compelled to incur additional expense in order to adhere to the statutory instructions, not to speak of the additional instructions that might be contained in the regulations. Naturally, to the extent that the expenses of trustees are increased, the amount of money paid to the Government in the form of income tax is decreased. It will be of small comfort to the average taxpayer to know that this proposed section of the code which is supposed to close a gapping loophole will, in fact, lose revenue for the Federal Government.

If the proposed section 669 is not an income tax producing provision, perhaps it has been designed merely to discourage the use of multiple trusts. Perhaps the taxpayer who might otherwise use a multiple-trust device in order to avoid income tax will be dissuaded by proposed section 669. If so, there will be no new multiple trusts and thus the cost to the Government of policing the new provision will not be too burdensome.

But this is not so. People who would make use of a multiple-trust device in order to avoid income tax will continue to do so even if proposed section 669 is enacted. There is no serious penalty contained in this section. It merely provides that as to the last 10 years of a particular trust, accumulated income will be taxed to the beneficiary as if the trust had not existed. Will this stop a person from creating 50 or 100 or 1,000 trusts for the benefit of a newborn child to accumulate income until the child has attained 40 or 45 years of age? I don't think so. In fact, I think it is possible, through an ingenious series of trusts and subtrust to minimize the effect of the 10-year throwback features of section 669.

On the other hand, consider the following case which will, for no reason other than the extremely broad language contained in proposed section 669, be deemed to be a multiple-trust situation:

In his will, J directs his trustee to divide his estate into two separate trusts, one for each of his named married children, K and L. The trustee is to pay to a child so much of the net income of his separate trust as the trustee deems necessary for such child's care, comfort, and support. When a child attains age 35, his entire trust is to be distributed to him. If a child dies prior to age 35, his trust is to be distributed to his descendants, per stirpes. If no descendants of such child are then living, the trust is to be distributed to J's other child. From and after J's death, the trustee pays all of the income of one trust to K and distributes that trust to K when he attains age 35. However, L is a spendthrift and the trustee determines that L and his wife and children would be better off if something less than all of the income of his separate trust were distributed to him. Therefore, from time to time, the trustee accumulates and adds to principal a portion of the income of L's trust. Nine years after J's death, when L is 35 years old, he and his entire family are involved in an automobile accident. L's wife and children are killed instantly and L dies a day later. When the trustee distributes L's trust to K there will be a multiple-trust distribution under section 669. Why?

Notice that no portion of the income of the trust originally set aside for K's primary benefit was ever accumulated. Nevertheless, because of the fact that, upon the termination of his own trust, K received a "section 669 distribution," that trust will be considered to be the "primary trust," and the distribution to K of L's trust will be deemed to be a "multiple-trust distribution."

Since proposed section 669 will neither produce a surplus of revenue nor discourage the creation of multiple trusts by persons seeking to avoid income tax, but will, instead, trap the unwary, it is strongly suggested that section 113 of H.R. 9662 be eliminated from the statute.

If, for some reason, it is deemed desirable to adopt the general approach contained in section 113, it is recommended that the following changes be made:

1. In order to avoid the expense attendant to the collection of relatively minor amounts of revenue and in order to provide the application of section 669 to a large number of relatively innocent situations, a series of exceptions to the operation of the multiple-trust rule should be provided. These exceptions might be substantially the same as those contained in section 665.

2. Section 669(a)(3) should be eliminated in order to maintain the conduit theory of trust income. It is my understanding that this provision may have been included in the new section to obviate difficult mathematical computations. However, the provision would, among other things, have the effect of converting tax exempt interest into taxable income. I can't belive that this is an intended result.

3. Section 669(a)(4) should be eliminated in order that the customary throwback option would be available. This would permit a distributee, if he so elected, to forego the lengthy multiple-trust computations and include all the multiple-trust distribution in his return for the current year. Remember, if you will, that the ordinary multiple-trust beneficiary may be a "trapped" one, and, therefore, we are not speaking of a large number of dollars. Section 669 will apply even if there is $1 of multiple-trust distribution for each of the preceding 10 years. Why force such a beneficiary to recompute his taxable income for 10 years?

4. As to section 6047, added by section 113(c) of H.R. 9662, does the Government really want a special information return every time that, roughly speaking, an amount is paid to a beneficiary from principal? In addition, just what kind of "other information" may the Secretary require a trustee to furnish? Is a return really to be filed even though there is no evidence of a multiple-trust situation? Who is going to process these returns? Who is going to tabulate and classify the information? Where are these returns going to be filed? Theoretically, none of them can ever be destroyed during the lifetime of a beneficiary. Consider the following situation:

P, during his lifetime, creates a trust for his son Q, which is to be distributed to Q when he attains age 21. P dies when Q is 20 years old. Under P's will, a second trust is created for Q's primary benefit. This testamentary trust is to terminate and be distributed to Q when he is 65. The living trust is distributed to Q when he is 21, one year after P's death. Forty-four years later the testamentary trust is distributed to Q.

Is it anticipated that, upon the distribution of the testamentary trust, Q will have in his mind or in his files the facts and circumstances which will enable him to determine if the living trust which was distributed to him 44 years earlier was a "primary trust" so that the current "section 669 distribution" is a "multiple-trust distribution?" I should think not. Without the aid of a computer, I doubt that the trustee (assuming that there was only one trustee involved) would know. It would appear then that the only source for this information would be the Government's 44-year-old records. I leave to your imagination the cost of such a filing system. Of course, in the final analysis it is the taxpayer who will underwrite this expenditure and, in my estimation, the average taxpayer will be prejudiced by the passage of section 113 because it will cost more to police this statute than will be collected in additional revenue.

I am grateful for the opportunity of presenting these views to you and I hope they will be helpful in your deliberations.

STATEMENT OF THE CHAMBER OF COMMERCE OF THE UNITED STATES ON H.R. 9662

TITLE II—PARTNERSHIPS

Title II of H.R. 9662 would amend the provisions of subchapter K of the Internal Revenue Code of 1954, relating to partners and partnerships. This bill originated with the work of an advisory group to the House Committee on Ways and Means which was appointed to review the partnership provisions of the 1954 Code to make recommendations for amendment.

The bill would retain the basic structure of the partnership provisions enacted in 1954. Unlike other major statutory provisions, those relating to partnerships were almost wholly new in the 1954 code. We believe that the basic framework of those provisions is sound, and until experience with them clearly demonstrates a need for basic revision, there is nothing to be gained from change for the sake of change alone. Therefore, we welcome the acceptance in H.R. 9662 of the basic structure of the partnership provisions enacted in 1954.

With some exceptions, we believe enactment of the legislation contained in H.R. 9662 will strengthen the partnership provisions of the code.

Proposed section 702 would provide a clear statutory provision stating that wherever specific limitations are imposed elsewhere in the code on the deductibility or includibility of any item, those limitations would be applied at the individual partner level rather than at the partnership level. The chamber supports this provision. The need for such a statement of legislative intent was demonstrated recently when Public Law 85-866 was enacted containing a provision for a limited "initial year" depreciation allowance. There was uncertainty among taxpayers and tax advisers alike whether the limit on the allowance would apply to a partnership or to its partners until the Treasury issued instructions for the 1958 partnership returns which had the effect of imposing the limit at the partner level. A statutory provision such as contained in proposed section 702 would resolve all such doubts clearly and consistently.

Another problem closely related to this arises where elections must be made by taxpayers regarding the treatment of specified items of income or deductions. The proposed section 702 should be amended to include a clear statutory rule governing these elections. Under the present rules all elections must be made by the partnership rather than by the partners, unless specifically stated otherwise. The chamber believes this rule is sound but recommends that it also be made clear that an election made by a partnership would be binding upon the partners only insofar as their income and deductions from the partnership are concerned. Otherwise a partner with only a minor interest in a partnership, and no effective voice in its management, may be deprived of his right to an independent personal election governing the same items which arise in his affairs outside the partnership.

Proposed section 704 would provide that a partnership year would close with respect to a deceased partner at the date of death, unless the successor in interest of the deceased partner elected to keep the year open until its normal close. This rule is a more realistic, practical, and equitable rule than the rigid one now contained in the code and urges its adoption.

Another provision which the chamber believes is desirable is that contained in proposed section 780. This would provide that the present election available to a partnership to adjust the basis of property on certain distributions in respect of transfers of partnership interests would be separated and made into two distinct elections. The transactions now governed by the single election, that is distribution to partners and transfer of partnership interests, are quite unrelated, and the factors influencing the desirability of an election to adjust basis are often quite different for each transaction. Furthermore, in the case of one transaction, the basis adjustments affect all partners, while under the other the adjustments affect only a transferee partner. Because of these essential differences, we believe the elections should be separate. Furthermore, we believe the de minimus rule provided in proposed sections 781 and 782, which would limit the applicability of these provisions to cases where the adjustment to basis aggregated $1,000 or more, is desirable and should be enacted.

A number of the provisions of H.R. 9662 are intended to remove certain differences which now exist in the treatment of transactions or items in the partnership area from the treatment applied to similar transactions arising in the corporate area. In general, the rules governing partnerships should be consistent with those governing corporations unless there is a compelling reason for a difference. For this reason the chamber urges the enactment of proposed section 765, which would amend the rules governing the treatment of gains and losses on transactions between partners and partnerships to make them more consistent with the rules governing such transactions between stockholders and corporations.

The chamber also endorses the provisions of proposed section 703(b) which would permit partnerships a deduction over a period of 60 months of organizational expenses. We note, however, that the definition of organizational expenses contained in proposed section 703(b) is considerably narrower than the definition originally proposed by the Subchapter K Advisory Group. The definition ad-

vocated by the advisory group is a more realistic one than the unreasonably restricted definition contained in proposed section 703(b), and should be adopted by the committee.

Proposed sections 749 through 751 would contain rules relating to "collapsible" partnerships. These rules would differ substantially from the present rules contained in the 1954 Internal Revenue Code.

While the chamber cannot strongly object to any of the specific rules contained in these proposed amendments, we believe that the problem of collapsible partnerships is sufficiently similar to the problem of collapsible corporations to warrant a coordinated effort to achieve a set of rules which can be applied with reasonable consistency to both partnerships and corporations.

While there is a serious problem in designing adequate and equitable rules to prevent abuse of the general partnership provisions by a taxpayer seeking to convert what otherwise would be ordinary income into capital gain by a sale or exchange of a partnership interest or by a distribution in respect of a partnership interest, the chamber has noted the recommendations of the Subchapter C Advisory Group to the House Ways and Means Committee on collapsible corporations and the substantial differences between the recommendations of the Subchapter C Advisory Group and the provisions in proposed sections 749-751. Because of these differences, and the belief that the rules for partnerships and corporations should be reasonably consistent, the chamber is not prepared at this time to support the changes contained in proposed sections 749 through 751.

In particular, the chamber believes that the following aspects of any collapsible rules should be the same for partnerships and corporations:

1. *The definition of collapsible assets.*—The provisions of proposed section 751 would define such assets to include substantially all assets the sale of which by the partnership would produce ordinary income. The Subchapter C Advisory Group definition is somewhat similar, but, in oversimplified terms, assets would cease to be collapsible assets if held for over 3 years, with special meaning in the case of inventories.

2. *The character of collapsible assets distributed to partners or shareholders.*—Proposed section 735 of subchapter K would preclude such assets forever from achieving true capital assets status. Regardless of their true nature in the hands of the individual partner, they would forever be tainted. Under the Subchapter C Advisory Group recommendations such assets distributed to shareholders would remain tainted for only 5 years. Thereafter their character would be determined under the rules relating to character of assets generally.

3. *The provision of a de minimus rule.*—Under the Subchapter C Advisory Group recommendations, the collapsible corporation rules would apply only to shareholders owning 5 percent or more of the stock of the collapsible corporation, regardless of the dollar magnitude of any gain involved. No such de minimus rule is contained in the provisions of H.R. 9662.

The chamber believes that the use of collapsible organizations to convert what otherwise would be ordinary income into capital gain is confined by practical considerations largely to closely held organizations. In such organizations there is a relatively high degree of freedom for the small group of individuals to choose either corporate or partnership form. Therefore, substantially the same restrictions on capital-gain treatment should apply, regardless of the form chosen. In view of this, and the major differences between the provisions of H.R. 9662 and the recommendations made to the Ways and Means Committee by the Subchapter C Advisory Group, the chamber urges that additional coordinated study be undertaken to develop rules which can be applied consistently to collapsible partnerships and corporations.

The provisions of title II of H.R. 9662 would accomplish a mechanical arrangement of the partnership provisions of the code to group together those covering most "simple" partnerships. This rearrangement is intended to make it unnecessary for partners in these simple partnerships to concern themselves with the more technical provisions which would be contained in later sections of subchapter K.

No changes in substance are involved here, but the chamber feels that there may be a danger that taxpayers seeking to make their own analysis of the partnership provisions of the code may overlook rules appearing elsewhere in subchapter K which may have a material effect on their tax liabilities. The goal sought by the mechanical rearrangement of subchapter K is largely illusory, and any slight advantage of this rearrangement would be substantially offset by the danger noted in the preceding sentence. For this reason, the chamber

believes it would be more satisfactory to make the changes in substance contained in title II within the existing arrangement of subchapter K. In this way, those provisions which would be changed by H.R. 9662 would be highlighted.

Proposed section 705 of subchapter K contains another change which is not necessary. This relates to the general rule for determining the basis of a partner's interest in a partnership. Under the proposed change the general rule would be that the basis is determined by a partner's proportionate share of the basis of the partnership assets. This general rule would be applicable only where it does not result in any substantial difference in basis from the partner's basis determined under existing rules. Manifestly it would be necessary to know approximately what basis under both sets of rules would be, and, therefore, the chamber does not believe the change to be either necessary or desirable.

The national chamber appreciates this opportunity to state its views.

The CHAIRMAN. The next witness is Mr. Austin Fleming of the Chicago Bar Association, accompanied by Emory S. Naylor, Jr.

Gentlemen, take your seats and proceed.

STATEMENT OF AUSTIN FLEMING ON BEHALF OF THE CHICAGO BAR ASSOCIATION, ACCOMPANIED BY EMORY S. NAYLOR, JR.

Mr. FLEMING. Mr. Chairman and members of the committee:

I am Austin Fleming of the Chicago Bar Associations' Committee on Federal Taxation and chairman of the Subcommittee on Income of Estates and Trusts. Mr. Emory S. Naylor is also a member of our tax committee. I shall speak to the parts of the bill relating to estates and trusts and Mr. Naylor will speak to the partnership aspects.

Our committee consists of approximately 40 attorneys from small, medium, and large law firms in the city of Chicago, men who are interested in the operation and application of the Federal tax laws and their impact on business and the affairs of people.

Now, in the remarks we are going to make today I should add that our committee was unanimous or substantially so on the points that we have to make.

I should say at the outset that our committee has followed the legislation embodied in this bill from the very outset when it was first being considered by the advisory group. We followed it through in its various phases, and we are still interested in it in all of its aspects. We have consistently urged the adoption of this particular legislation, and we want to go on record today as urging its adoption by the Senate.

With one or two exceptions, this bill is a clarifying measure. It will not affect the revenue one way or the other. Its primary purpose is to remove the angularities and the inequities that developed in the 1954 Code in the area of estates and trusts. It is a bill designed not only to remove the angularities of the code but also to make it easier for lawyers and people who are charged with the administration of estates to do things in the accustomed, normal way without having tax traps and unintended tax results flow from their actions.

There are several sections of this bill which are urgently needed and therefore we hope that it will be possible, even in spite of the crowded calendar the Senate has, to see that this bill is acted upon before the close of the session.

I think enough has been said today and yesterday in connection with the multiple-trust section of the bill. We, too, feel that the multiple-trust provisions would best be deleted from it. We are not in position

to say whether any legislation on multiple trusts is called for, but if it is, it ought to be in a separate measure.

Also we prefer the approach of the advisory group on the multiple-trust problem rather than that expressed in the present bill.

Continuing in the area of estates and trusts, we have noted in our full report filed with the committee, a number of small but important drafting suggestions, some of which we think are inadvertent omissions on the part of the drafters of the bill. Others are needed to carry out the full intent of the measure. For example, changes have been made in the first sentence of paragraph A on page 6 of the printed bill, dealing with capital gains, but not in the second sentence dealing with losses. As a result, the two sentences do not dovetail.

On page 8, line 10, of the printed bill, there is an inadvertent omission in the parenthetical clause of any reference to the deduction for distributions made to beneficiaries. Without that particular provision, the section does not operate in the way that the drafters intend it to work.

On pages 12 and 13, and 15 and 16, the drafters have injected an unintended ambiguity in the paragraph dealing with the tier arrangements, by using the words "beneficiary to whom payments may or may not have been made," as determining the applicable tier, rather than the character or source of payment as between principal and income. As the result of this unintended shift in the approach taken by the language, it becomes difficult, if not almost impossible, to apply the section. We have indicated in our full statement how we think that this ambiguity can be removed. If removed, we believe the amendment in regard to the tier arrangements would represent a workable and appropriate tax structure.

The section which we feel most strongly about and which we find our friends from Philadelphia and from the chamber of commerce agreeing with, is section 108, amending code section 663 appearing on pages 18 to 20 of the printed bill.

The approach of the 1954 code was to treat every distribution made by an executor or a trustee from an estate or trust as income, with income tax consequences, regardless of whether that distribution came from income in the traditional sense or from corpus. Now, because that general rule would obviously be too broad, certain exceptions were made in section 663 taking away from the general rule of income attribution certain distributions such as bequests under a will, amounts paid to a charity, and so forth.

Now, unless the exception section is carefully drawn, you may get some very weird results from its application. For example, the family car and the family silverware may be taxed as "income," contrary to every intention and proper tax approach.

That is what happened under the 1954 code. The exclusionary section was too limited in scope and led to numerous corpus distributions being treated for income tax purposes as taxable "income."

The present bill purports to broaden the section and to correct some of these shortcomings. This objective is altogether proper and desirable but it does not go far enough and the bill does not except all the types of distribution it should.

For example, the bill quite properly substitutes a 36-month period during which distributions from an estate may be made without hav-

ing the distributions treated as taxable income, for a "three-installment" rule. Unfortunately the drafters of the bill have limited the provision to estates, testamentary trusts, and revocable trusts, whereas previously under the present law the wording is "governing instrument."

Now, no reason is seen why you should exclude other types of trusts such as irrevocable trusts or trusts revocable with the consent of third persons, where the identical need for an exception from income attribution exists. Therefore it seems to us that the bill should retain the present wording of "governing instrument" and the language of paragraph (b) on page 19 of the printed bill relating to the 36-month limitation, can be revised to refer to estates, testamentary trusts, and fully revocable trusts if that seems desirable.

The same subsection should be expanded to cover, specifically support awards and family allowances paid from the principal of an estate. These awards are not strictly "bequests and gifts," so that they do not strictly fall within the wording of section 663 as it is now drafted. Yet the same reasoning, the same rationale applies to these support awards as applies to a bequest under a will. And for that reason we have suggested that there be added to the section an express provision that would include these support awards and allowances in the same category as gifts and bequests.

Finally, and this is of great importance, the bill adds a new exclusionary paragraph called "Other gifts, bequests, designed to eliminate any attribution of income for distributions made from the capital of an estate or trust."

Here again, the purpose is altogether proper and as it should be, but it has not gone far enough. It is limited to "real property and tangible personal property," which takes care of the family car, the home, and the silverware. But the same reasoning would equally apply to the shares of the family business and for that matter any property owned by the decedent at the time of his death and which finds its way into the corpus of a trust or into the hands of a legatee or distributee under a will.

We believe the approach of the advisory group was much sounder at this particular point. They suggested that the books of the fiduciary be determinative of whether the distribution constituted corpus of the estate or trust or income. Next to this, the alternative proposed suggested by the advisory group at the request of Congressman Mills, and which appears on page 80 of the final report of the advisory group would be preferable, viz: that any property owned by the decedent at the time of his death be treated as an exception to the exclusionary rules and exempted from the attribution principle.

This concludes the discussion we want to make in our oral presentation regarding estates and trusts. Mr. Naylor will speak to you on a few points we have regarding the partnership aspect of the bill.

Thank you.

The CHAIRMAN. All right, Mr. Naylor, you take a seat, sir.

Mr. NAYLOR. Mr. Chairman and members of the committee, I am a practicing attorney in Chicago, Ill., and member of the Committee on Taxation of the Chicago Bar Association.

As far as the partnership provisions are concerned, we are particularly concerned with the following items:

The first is section 702(e) of the proposed bill. This is the election for simplified reporting. We believe that as far as this provision is concerned that it will serve primarily as a trap for the unwary. The election is not a revocable one. It does provide an additional complication. In other words, it is an additional election which must be considered every year. The penalty is the loss of deductions or exclusions which are limited to fixed amounts or a percentage of income.

We believe that this provision should be deleted from the proposed bill.

Our second point is in connection with the deduction of organizational expenses. That is section 703(b) of the proposed bill. We are in favor of the ability to deduct organizational expenses but we believe the provision of the bill is too narrow. We are of the opinion that frequently partnerships will of necessity revise their partnership agreement and as such expenditures of that type in that connection should also be treated in the same fashion as those of initial organization.

In other words, we would favor expanding the provisions of section 703(b).

The third provision is section 741 of the proposed bill that is in connection with the gain or loss on the sale or exchange of an interest. It is often difficult to determine in a particular case particularly in a situation where you have a two-man partnership, whether there has been a sale by one partner to another or a liquidation of a partner's interest in a partnership.

As a result, we believe this should be tied to section 776 of the proposed bill, and with an addition which would state something to the effect that—

> To the extent that such sale or transfer is to the partnership or ratably to the remaining partners, the provisions of section 776 shall apply.

In that way, by putting a provision of that sort in, you would avoid the problem of interpretation as to which section you were under. We do not believe that should be left up to the drafting since the economic substance is the same in either event.

A fourth provision in which we are interested, is section 749, sales and exchanges of interests in partnership which result in ordinary income. This is part of the so-called collapsible partnership provisions. We are concerned here at the problems that will be created for partnerships, particularly service partnerships.

Where there is a transfer of a partnership interest and you have substantial unrealized receivables, take, for example, in the situation such as a law partnership, accounting partnership, engineering, architecture, any service partnership of that sort—frequently you would have a large amount of unbilled and uncollectible receivables. To force you to total them up and estimate what they are—and I might say, all you can do is estimate because you may have contingent fee arrangements and there can be any number of situations where you would not know what the exact amount would be.

In order to make an apportionment of that type of an asset, it would be considerable work and difficulty for the average partnership. As a consequence, we believe that the provision should only operate where there is an overall gain in the transaction.

Thus where a partner, in effect, only receives an amount equal to his basis for his partnership interest, it would not be necessary to go to this additional work. We think it is also not only a question of work but we feel to allow the provision to stay the way it is might hinder the administration of new partners in many of these partnerships.

Section 750(a) of the proposed bill deals with distributions which result in ordinary income. This particular provision, from a theoretical point, is entirely proper. We cannot quarrel with it from that standpoint at all. But we do feel that the provision is entirely too complicated, and will not be understood by average partners. As a consequence, we would recommend that this provision be deleted.

Section 770 of the act which deals with interests in partnership capital that are exchanged for services, we believe that in order to avoid any misunderstanding in connection with that provision that it is important to add a provision to indicate that unrealized appreciation of section 751 assets, essentially uncollected receivables is what we have in mind, should not be included in determining the value of the partnership interest. We believe that this is important since we do not believe that a partnership should be taxed at the time he receives his partnership interest on the unrealized receivables and then later taxed on the same unrealized receivables at the time they are received because he will then be a partner and pick up his pro rata share of the same exact items at that time.

So in order to avoid the double tax possibility there, we believe that that addition should be made.

In the case of section 780 of the proposed bill, it provides for a stepped-up basis of partnership assets if an election is made within 1 year after the date prescribed for filing the partnership return.

The 1 year will be adequate in most cases. However, in the situation of an estate we do not believe that such a provision will be adequate because the Federal estate tax return will, in all likelihood, have not been audited by that time and as a consequence the necessary information in order to determine whether an election should be made will not be available. As a consequence we would suggest that the time for making the election under that provision be extended in the case of a deceased partner's interest to a provision that would be comparable to, let us say, section 303(b)(1) of the code which, in substance, extends it out so that it is the period of assessment for Federal estate tax return purposes, plus 90 days, or tie it into the finality of the Tax Court decision.

Thank you very much. I would like, if we could, to have our prepared statement made a part of the record.

The CHAIRMAN. That insertion will be made.

Thank you much, Mr. Naylor.

(The prepared statement submitted by the Chicago Bar Association follows:)

STATEMENT OF COMMITTEE ON FEDERAL TAXATION OF THE CHICAGO BAR ASSOCIATION

The Committee on Federal Taxation of the Chicago Bar Association appreciates the opportunity to present its views on H.R. 9622 (Trust and Partnership Income Tax Revision Act of 1960) now under consideration.

Our committee consists of approximately 40 attorneys in the Chicago area who are interested in the Federal taxing statutes from the standpoint of equity,

certainty, ease of administration and compliance, and the impact of Federal tax laws upon other areas of the law.

The committee has carefully reviewed H.R. 9662 and is of the view that it is desirable legislation, and with the exceptions hereinafter mentioned, we wish to go on record as favoring its adoption.

TITLE I—ESTATES AND TRUSTS

Except for the new section 669 on multiple trusts, the proposed act should improve greatly the administration and practical application of the 1954 Code in the area of estates and trusts. We are, however, of the opinion that certain changes are advisable to achieve fully the objects of the bill. We note them below.

1. Section 103(b) amending section 643(a)(3)(A): Capital gains and losses

Section 103 of the bill makes conforming amendments to code section 643 (a)(3)(A) in order to carry out the proposed treatment of charitable beneficiaries. However, the changes are made only in the first sentence of the subparagraph, dealing with capital gains, and not the second sentence dealing with losses. The two sentences do not dovetail and a possibility is created of doubling deductions at the trustee level, with one deduction for gross gains and another for losses.

The wording of the second sentence of the subparagraph should be revised to make it clear that the deduction is only for net gains after offsetting losses, if any. This could perhaps be done by deleting that part of the second sentence beginning with the word "which" (line 2, page 7, printed bill) and substituting: "* * * which are not excluded under the preceding sentence."

2. Section 103(b) amending section 643(a)(3) to add new subparagraph (C): Corpus deductions

Section 103(b) of the bill adds a new subparagraph (C) to code section 643(a)(3) to provide that corpus deductions shall first be applied against any corpus income taxable to the trust or estate before becoming available to the income taker.

The purpose of this addition is desirable. As drafted, however, the wording does not achieve the stated purpose, and the example on page 48 of the House report is incorrect for the reason that the wording of (ii) of the proposed new subparagraph fails to exclude any deduction for distributions under section 643(a)(1). As a result, a trust or estate which pays a corpus charge and has taxable income (e.g., capital gains) against which the corpus charge could be offset, is not given first call on the deduction as is the intent, but second call after the income beneficiary whose distributions, under the wording of the amendment, must first be deducted from the corpus charge before becoming available to the estate or trust.

This defect could be eliminated by inserting after the word "subparagraph" in line 10, page 8 of the printed bill, the words: "* * * or to subparagraph (1) relating to deduction for distributions."

3. Sections 106 and 701 amending sections 661 and 662: Tier system

The bill adopts a three-tier system for taxing the income of trusts having more than one beneficiary. If charitable distributions are involved, they are made a fourth tier rather than being allowed to fall in whatever tier they would otherwise belong, if paid to an individual.

Under the tax structure adopted by the 1954 Code for taxing the income of trusts and estates, some kinds of rules are necessary to determine what part of the taxable income of a trust or estate is chargeable to each beneficiary when there are two or more beneficiaries of the same trust.

The 1954 Code drew some arbitrary distinctions in this regard which have given trustees and their beneficiaries, as well as their lawyers and accountants, considerable difficulty and have caused a great deal of complaint. For example, the code lumps together a trust beneficiary who receives only incomes with a beneficiary who receives only principal, with the result that the beneficiary who receives only principal is required to pay an income tax on that principal even though he in fact receives no income. Obviously, such a result calls for change in the law.

The remedy which the bill adopts is to distinguish between different types of distributions and place them in three separate categories or "tiers," except for charitable distributions which are placed in a fourth.

The first category includes only those distributions which may be made from income whether paid pursuant to direction in the instrument or in the exercise of a discretion by the fiduciary.

The second category consists of amounts paid only pursuant to the exercise of a discretion by the fiduciary out of income or principal.

The third consists of all other distributions (except charitable contributions), and will normally consist of distributions from corpus.

Assuming for the moment that a three-tier system is desirable, it appears to us after reading the House report and the bill that the drafters have injected an unintended ambiguity in the section by using the words "beneficiary to whom" payments may or may not be made, as determinative of the applicable tier rather than the character or source of the payment, as between income and principal. Instead of letting the character of the payment determine the appropriate tier, the language of the amendment inadvertently shifts to the identity of the beneficiary and makes it determinative of the applicable tier. As a result, it is difficult to apply the section.

Accordingly, our first suggestion—assuming the three-tier system is retained—is, in each of sections 661 (a) and 662 (a):

To delete from (1) the words "to whom no amount may be paid or credited during the taxable year except from" and substitute "only out of"; and

To delete from (2) the words "to whom amounts may be paid or credited during the taxable year" and substitute "either."

If these changes were made, the amendment would then represent a workable tax structure. However, our committee believes the proposed second tier should be eliminated altogether. It sets up a test or standard which does not permit ready application to the variety of trust instruments in common use and does not serve a helpful purpose. The wording refers to amounts that "may" be paid in the discretion of the fiduciary from income or corpus. Frequently, principal encroachment clauses are drawn which are in effect a direction to invade in case of the occurrence of specified contingencies as, for example, if the beneficiary sustains extraordinary expenses due to illness. If the trustee makes payment under such a clause, does the distribution fall in the second tier or the third tier? Again, it is possible that a beneficiary might be in tier (1) in one year and tier (2) in the next, depending not on the instrument but on external circumstances.

We believe other questions of application will arise to cloud the workability of the section. In the interests of simplicity, tier (2) might well be eliminated and the income element combined with tier (1) and the corpus element with tier (3). This, in fact, is what the present code does with respect to mandatory payments. See present section 661(a)(1) and section 662(a)(2).

As for charitable distributions, the relative infrequency with which they occur in trusts with more than one beneficiary renders their treatment for purposes of section 661 not of great consequence. However, a majority of our committee favors deleting the word "paid" from the so-called fourth tier (line 15, p. 13, printed bill) so that as to payments actually made to charities (as distinguished from those set aside and held for their use), such payments will fall in whatever tier they would otherwise belong if made to an individual, leaving to the fourth tier only those amounts which are permanently set aside or held for the use of charities.

4. Section 108 amending code section 663(a): Exceptions to income attribution

Code section 663 sets forth certain exceptions to the rules of attribution of income under section 661(a) and section 662(a). In practice, it has become evident that this exclusionary section is too limited in scope and leads to numerous corpus distributions being taxed under section 662 as "income."

The bill purports to expand the section and correct these inequities. In section 663(a)(1) it would broaden the exception relating to amounts distributed as a gift, bequest, or devise, to substitute a 36-month period from the death of the decedent for the previous "3 installment" rule, and to include not only lump-sum gifts and bequests paid all at once, but also payments made in any one taxable year. For reasons not stated in the House report, the amendment actually contracts and narrows the application of the section, so that where as formerly it applied to any amount which under the terms of the "governing instrument" was paid all at once or in not more than three installments, it is now limited to an "estate, trust created by will, or a trust which * * * was revocable by the grantor acting alone." The reason for excluding other types

of trusts such as irrevocable, or revocable only with the consent of a third person, where the same identical need exists for an exception for attribution, is not apparent.

We believe the prior wording of the section, viz., under the terms of the "governing instrument," is preferable, and should be retained. If necessary, subparagraph (b) relating to the 36-month limitation might be reworked so as to apply only to estates, testamentary trusts, and fully revocable trusts, if this seems advisable.

We also believe the same subsection (1) should be expanded to cover specifically, support awards and family allowances paid from the corpus of an estate. Such awards and allowances are not a "gift, bequest, or devise" but are made under local statutes. Nevertheless, the reason for their exclusion from the income attribution rules is identical with that of gifts, bequests and devises. We suggest that there be added to subsection (1) (line 3, p. 19, printed bill) after the words "specific property": "* * * or as an award or allowance from the corpus of a decedent's estate for the support of a spouse or child."

The bill would also add a new exclusion called "Other gifts, bequests, etc." which is designed to eliminate any attribution of income for distributions from the corpus of an estate. Under existing law, the distribution of the family car and silverware, for example, may be taxed as "income."

The bill adopts what the House report (p. 12) calls a "distribution in kind approach" to permit exclusions for distributions from an estate of real property and tangible personal property owned by the decedent at the time of his death. Our committee believes this amendment, insofar as it limits its application to "real property or tangible personal property," does not go far enough and should be expanded. For example, it would not cover the distribution of shares of a family business distributed from an estate, and as to which there seems to be no difference in principle from a parcel of real property or a family car.

In lieu of (2), we urge the Senate to adopt the following substitute (which is the second alternative proposal prepared by the Subchapter J Advisory Group at the request of Congressman Mills and which appears on p. 80 of the final report): "Any property (other than money) owned by the decedent at the time of his death, or any property the basis of which is determined by reference to property so owned."

Finally, our committee observes that the amendment creates three distinct rules which fiduciaries, attorneys, and accountants must bear in mind in applying this section of the code, namely:

1. The amendment applies only to testamentary arrangements (estates, testamentary trusts and fully revocable trusts) as to which the decedent dies after passage of the act;
2. As to all other existing trusts, the old code provisions are continued in effect indefinitely;
3. As to new inter vivos trusts which are irrevocable or revocable with the consent of third persons created after passage of the bill, no exceptions from the attribution rules exist.

No provision is made for existing estates, although from a reading of the House report, it would appear that this was an unintended omission, and that the drafters intended to cover existing estates as well as existing trusts (line 12, p. 20, printed bill).

Such a variety of rules seems to our committee to create unnecessary complexity and defeat clarification. The suggestions offered by our committee would eliminate the necessity for these complicated, separate rules.

5. Section 108(b) amending code section 663(c): Separate shares

Section 108(b) of the bill would extend the separate share rule to estates. This is a highly important and necessary amendment.

However, the bill would also add a new subsection (d) to provide for the allocation of income and deductions when a new trust is created ("peeled off") out of the assets of an existing trust in order, for example, to take care of an after-born child, and is a complement to the amendments made to the 5-year "throwback" section (sec. 665 (b)(6) and (e) contained in sec. 110(c) of the bill.

Our committee believes that subparagraph (2) of the new subsection (d) is too narrow and should be broadened to cover not only the "spinoff" of a trust (as may occur when a subsequent child is born) but also a "splitup" of a trust (as may occur when, following the death of a life tenant, the trust divides into a new

set of shares or trusts), with the same rule for allocation of income and deductions between the old and new trusts applying to a "splitup" situation as applies to a "spinoff" or "peeloff" case.

6. Section 110 amending code section 665(b): 5-year throwback

The bill adds two new exceptions to the "5-year throwback" rules in section 665(b), which are designated as (5) and (6).

New exception (5) would exempt from the throwback rules a final distribution of a trust when a beneficiary reaches a specified age. As drafted, exception (5) relates only to testamentary trusts and trusts revocable by a grantor acting alone. Our committee believes it should also apply to other trusts of which the grantor would be treated as owner prior to his death under subpart E.

Exception (5) fails to make an exception to the "throwback" rule for a final distribution occurring by reason of the death of another person, although the same reason for an exception to the rules would exist. Our committee believes the circumstance of death should be expressly covered in an additional separate exception, and this additional exception should apply to all trusts.

New exception (6) would exempt from throwback rules, a required distribution from one trust to another, but only if the distribution is "not related to the occurrence of an event which caused the distributing trust to terminate." Our committee believes that this quoted limitation should be broadened to include the "splitup" of trusts as well as the "spinoff" of trusts, as is suggested above in relation to the separate share section. It is common for a testator to establish trusts under his will for children for their lives and on the death of any child without issue to "crossover" his share to the shares of brothers and sisters. Such a crossover would represent a "splitup" of a trust rather than an "spinoff." No reason exists for application of the throwback rule in either circumstance. A proportionate part of any accumulated income of the distributing trust should be carried over to the receiving trust, so that it would be taken into account in any distributions to the beneficiary of the receiving trust.

7. Section 113 creating a new code section: Multiple trusts

Our committee has carefully studied section 113 of the bill which creates a new code section 669 dealing with multiple trusts.

If Congress believes that legislation in the area of multiple trusts is required, our committee favors the approach to the problem taken by the Subchapter J Advisory Group of consolidating the several trusts above a specified, permitted, minimum number to reach increased surtax brackets, rather than a "throwback" approach. We also consider that any statutory standards on consolidation should not be conclusive, but should only create a presumption in favor of consolidation, unless taxation as a motive in the creation of multiple trusts is rebutted by the taxpayer. Such a test provides a sufficient deterrent against abuse without sacrificing a basic fairness in the law which is desirable.

We are opposed to the "throwback approach" adopted by the bill, and specifically to the provisions thereof appearing in section 113. The principle of "throwback" is untested and untried, and its effectiveness, practicality, and enforceability are as yet undetermined. To extend it at this time to new areas of application seems to us unwise. Also, as drawn, the proposed section is too sweeping and cuts more deeply than the evil requires. It will be difficult to enforce and expensive to taxpayers. The device of throwback is essentially an "after-the-fact" remedy and is not suited to the type of problem presented by multiple trusts.

Aside from the policy question we find the drafting of the new section deficient in several particulars:

1. None of the exceptions which appear in the 5-year throwback section (sec. 665) is carried over to the proposed new section 669. The same reasons for including exceptions in the one case apply to the other, except for the special one in section 665 dealing with pre-1954 trusts. Without such exceptions, the proposed section will cause the multiple trust throwback to apply to distributions of accumulated income which are legitimate and proper and in no wise reflective of a "multiple trust" motive.

2. The "character rules" of section 662(b) do not apply. This will have the effect of taxing accumulations of tax-exempt income as ordinary income.

3. There is no requirement that the first of the several trusts contain accumulation provisions, so that a trust which must distribute all of its income currently may nevertheless "trigger" a multiple trust throwback in another trust of the same grantor which happens to overlap only for a brief period of time.

4. The number of returns which will be required to be filed under new section 6047 will lead to a "seif" of papers being furnished to the Government, with added expense to fiduciaries and an increased burden on Government personnel to sort, classify, and utilize.

The questionable results of the proposed new section 669 can be illustrated by the following example:

A creates a trust inter vivos for his son, to pay the income currently until the child reaches age 25 and then to distribute the corpus to him. The day before the son reaches 25, A dies and under his will he creates a testamentary trust which directs the estate to be invested in municipal bonds and the income to be paid out or accumulated until the son reaches age 50, when the corpus and accumulations are to be paid over to him.

Section 669 would tax the entire undistributed income for the last 10 years of the testamentary trust to the son upon receipt even though (1) the inter vivos trust did not permit accumulation, (2) the income is wholly tax-exempt, and (3) the two trusts coexisted only for 1 day, 15 years before the accumulations which the bill would require to be "throwback" began—each of these factors showing rather clearly that no "multiple trust" motive or effect was present in the creation of the two trusts.

If the section is retained, it is the view of our committee that it should be modified to:

1. Permit application of the character rules;
2. Limit application to those trusts only, of the same grantor, which accumulate income during the 10-year period to which the throwback applies;
3. Include applicable exceptions comparable to those under the 5-year throwback rules in section 665; and
4. Give the beneficiary the same election as is provided under section 668(a) to pay the smaller of (i) the sum of the taxes for the earlier years and (ii) the tax resulting from including the undistributed income in the current year.

TITLE II—PARTNERS AND PARTNERSHIPS

In the area of partners and partnerships, our committee is of the view that the proposed act will clarify the present complex partnership provisions of the 1954 Code. The spelling out of appropriate rules, in the manner which the bill proposes to do, should aid in the workability and acceptability of those provisions. Here again, however, in order to achieve fully the objects of the legislation, we believe the following changes should be made.

1. Section 201 adding code section 702(c): Election for simplified reporting

The bill would add a new subsection to code section 702 to provide an election for simplified reporting for tax purposes. The simplification would be achieved by allowing the partnership to consolidate most items of income and deduction into a single figure for the partnership taxable year. However, if the partnership elects to report on this simplified basis, the election cannot be revoked for that year without the consent of the Secretary or his delegate.

Our committee favors simplifying tax reporting wherever possible, but we believe this proviision will be rarely used except by inadvertence and without an awareness of its effect. If a partnership makes the election, the partners will forgo the benefit of certain credits and/or deductions such as a charitable deduction. The irrevocability feature could create a trap, since subsequent developments could make a change highly desirable. Taxwise the election always works against the taxpayer. The provision, if included, adds one more election which must be considered annually. Under all the circumstances, our committee favors deleting the subsection. Otherwise it should be amended to allow unconditional revocation.

2. Section 201 adding code section 703(b): Deduction of organizational expenses

The bill would add a new section to code section 703 to provide for the deductibility of organizational expenses of a partnership.

Our committee approves of this addition, but recommends that the scope of the section be broadened not only to include organizational expenses as such, but also costs of revisions and substitutions of partnership agreements.

3. Section 201 amending code section 741: Recognition and character of gain or loss on sale or exchange

The bill would replace existing section 736 with a new section 776 designed to clear up problems which arise in connection with payments in liquidation of the interest of a retired or deceased partner. However, new section 776 leaves unchanged section 741 providing that on the sale of a partnership interest the gain shall be treated as a gain from the sale of a capital asset, except to the extent attributable to substantially appreciated section 751 assets.

It is often difficult to determine from the legal documents in a given case, especially in a two-man partnership, whether there has been a sale by one partner to another or a liquidation of a partner's interest in the partnership. Since the sale from one partner to the partnership itself or ratably to the remaining partners has the same economic effect as a liquidation, it is suggested that the following language be added to section 741: "To the extent that such sale or transfer is to the partnership or ratably to the remaining partners, the provisions of section 776 shall apply."

4. Section 201 adding code section 749: Sales and exchanges of interests in partnerships which result in ordinary income

The bill would add a new section 749 which would contain the provisions of present section 751(a) providing for treating as ordinary income that part of the gain from the sale or exchange of a partnership interest attributable to unrealized receivables and substantially appreciated inventory items. However, the new section 749 goes on to provide that such ordinary income treatment shall apply whether or not there is an overall gain on the transaction.

Our committee objects to this provision because it does not accord with the economics of the situation and it will seriously impede the transfer of partnership interests and the admission of new partners to firms. It is well known, for example, that professional partnerships such as those for the practice of law, medicine, accounting, architecture, engineering, and the like frequently admit new partners by the transfer of a portion of the interest of one or more existing partners for a consideration equal to a proportionate part of the partnership's basis for its furniture, fixtures, cash, and cash items. In these cases, goodwill and unrealized receivables are ignored. Since there is no gain to the selling partner upon such a transaction, there is no occasion under existing law to create ordinary income in the selling partner. The purchaser is taxed upon his share of the unrealized receivables as they are collected.

Under proposed section 749, the selling partner would be required to make an allocation of the purchase price between substantially appreciated section 751 assets and other assets, thus creating ordinary income and offsetting capital losses. Aside from the unfairness of this result, the task and cost of analyzing unbilled and uncollected accounts and appraising contingent fees and charges, to estimate the value of unrealized receivables would be prohibitive. What is true of professional partnerships may be equally true of other types of partnerships. For these reasons, our committee favors providing for separation or fragmentation only if there is an overall gain on the transaction. Where there is an overall gain, the gain attributable to substantially appreciated section 751 assets should be limited to the overall gain.

5. Section 201 code 750(a): Distributions which result in ordinary income

In proposed section 750(a) the bill would retain and expand the provisions of existing section 751(b) dealing with situations in which disproportionate distributions are treated in part as sales or exchanges between the distributee partner and the partnership. Our committee believes the provisions of section 750(a) are too involved and complex for the average partner to understand and live with, and should be deleted, even though to do so may be at the possible expense of absolute equity between taxpayers. The elimination of section 750 might result in some shifting of tax burden between the partners, but should not result in any significant loss of revenue to the Government; nor will it permit the conversion of any substantial amount of ordinary income into capital gain. This position accords with that of the advisory group. See page 38 of its revised report which states:

"The group believes that the present version of this provision (sec. 751) is too complex to expect the average partner to know how to apply it and that it must be simplified even though in so doing some of the theoretically correct results of the present provision may be lost."

6. Section 201 adding section 770: Interest in partnership capital exchanged for services

To avoid any misunderstanding of the scope of section 770, our committee recommends that there be added to the section the sentence: "The value of an interest in the capital of a partnership shall not include any unrealized appreciation of section 751 assets."

This will make it clear that a new partner in a cash-basis service partnership, such as a legal, medical, accounting, architectural, or engineering partnership, will not be taxed on unrealized receivables at the time of his admission. This is an equitable result because he will include his share of these items in income when they are billed or collected, and he should not be taxed twice, once as a result of his acquisition of his partnership interest in them and again when they are collected. Also, it avoids having to estimate uncollected fees, some of which may be contingent.

7. Section 201 adding code section 780: Manner of allocating optional adjustments to basis

Proposed section 780 would permit a stepped up basis of partnership assets for the benefit of a transferee partner if an election is made by the partnership within 1 year after the date prescribed for filing the partnership return.

A 1-year period may be adequate in most cases arising under this provision. However, where a transfer occurs by reason of the death of a partner, the 1-year limitation could create a hardship if the value of the deceased partner's interest is substantially increased on audit of the Federal estate tax return. This normally occurs more than 1 year after the partnership return is filed.

In order to prevent hardship in this type of case, our committee suggests that there be added to proposed section 780 a provision that in case of the death of a partner and the substitution of his successor or successors in interest, the election may be made within a period comparable to that prescribed for a redemption of stock under section 303(b)(1), if the audit of the Federal estate tax return results in an increase in the value of the partnership interest over that originally reported in such return.

Respectfully submitted.

COMMITTEE ON FEDERAL TAXATION,
CHICAGO BAR ASSOCIATION,
By MAX E. MEYER, *Chairman*.

Dated April 1, 1960, at Chicago, Ill.

The CHAIRMAN. The next witness is Mr. Robert L. Woodford of the American Bankers Association.

Take a seat, sir, and proceed.

STATEMENT OF ROBERT L. WOODFORD, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. WOODFORD. Mr. Chairman, Senator Williams, Senator Bennett: I am Robert L. Woodford, a vice president and trust officer of the Delaware Trust Co. of Wilmington, Del. I appear here, however, as chairman of the Committee on Taxation of the Trust Division of the American Bankers Association to present to this committee our views on the proposed amendments that appear in title I of H.R. 9662 relating to taxation of income of estates and trusts.

The members of our association, of course, have a vital interest in this bill because the bulk, the overwhelming majority, of all fiduciary income tax returns are prepared in the banks and trust companies throughout the Nation.

In the main, we believe these amendments are soundly directed toward the objective of eliminating inequities and unintended benefits that exist under present law. There are, however, at least two proposed amendments which we believe to contain features inconsistent with the objectives of the bill and which should receive the particular attention of the committee.

The first of these is the provision in section 108(a) of the bill, which adds a new paragraph (2) to section 663(a) of the code, dealing with distributions in kind from the corpus of a decendent's estate to a beneficiary or residuary legatee. It provides that if (i) the distribution is made within 36 months of the date of death, (ii) the property distributed was held by the decedent at the time of his death and (iii) the property distributed is real estate or tangible personal property, the distribution will not be treated as income to the legatee nor will it be a deduction to the estate. The first two of these requirements are completely sound; the third is good as far as it goes, but it is much too narrow.

The object of this provision is to permit the executor during the period of administration or settlement of the estate to make necessary or desirable distributions to legatees of property left by the decedent without subjecting the distributee to a tax on income of the estate where the executor in the proper exercise of his discretion retains the income to provide for the payment of actual or contingent expenses or liabilities chargeable to income. Under existing law this treatment is permitted only with respect to distributions in satisfaction of bequests of specific property or specific sums of money.

The amendment in the bill would extend this treatment to distributions of real property or tangible personal property, other than money, whether or not in satisfaction of specific bequests, such as, for example, the distribution to the widow of the family home or car, or jewelry, furniture and the like, under a residuary bequest. The amendment as drawn falls far short of its objective by failing to include distributions of intangible property held by the decedent at death, such as stock, securities, notes, contracts, life insurance policies, on the lives of third persons, partnership interests, patents, copyrights, and the like. We believe this to be a serious deficiency in the bill.

Unless the amendment is broadened to include such intangible property, executors will continue to be seriously hampered in the proper performance of their duties in administering estates, and beneficiaries will continue to be taxed on income they do not receive.

The principal duties of the executor are to marshal the assets of the estate, determine its liabilities, decide what assets are to be liquidated to pay estate taxes and other liabilities, to pay those liabilities, and to distribute the remaining property to the trustees or legatees as soon as practicable so that the trustees or legatees can determine for themselves what is to be done with the property and, if investment policy is involved, what the long-range investment policy of the trust or legatee is to be. The executor should not be forced to distribute income where, in his judgment, the income should be retained to provide for the payment of expenses or liabilities.

Moreover, there is no good reason for limiting the executor's freedom to act in the best interests of the beneficiaries in timing distributions of any property left by the decedent, or for imposing penalties on such distributions, where, as provided in the amendment under consideration, the Government's interest in preventing manipulation for tax avoidance purposes is amply protected by the restrictions that the property must have been held by the decedent at death and that it must have been distributed within 36 months after death.

It is not necessary to exclude intangibles, such as stock or securities, from the desired treatment in order to prevent the executor from

buying securities for the purpose of distributing them as a disguised income payment. Complete protection against this kind of manipulation is assured by the requirement that the property distributed must have been held by the decedent at the time of his death.

There are many situations in which executors would be frustrated in the performance of their duty to act in the best interests of the estate and the beneficiaries if the amendment is not broadened.

For example, if the decedent has left a controlling stock interest in a family corporation to the residuary legatees, an early distribution of this stock to the legatees may be dictated by important business considerations although retention of the year's dividends from this stock may be considered essential by the executor to cover expenses and liabilities of the estate. Unless the stock can be distributed without its being deemed a distribution of estate income, the legatees will be unnecessarily penalized by being charged with an income tax on the receipt of corpus because of action that has to be taken for urgent business reasons.

Conversely, the legatees will be prevented from taking such action if the executor fails to make the distribution because of the penalty on the legatees that would result from it. In other instances, if the distribution is made the legatees may not have the cash to pay the income tax with which they have been inequitably charged.

Another situation commonly encountered is that of the decedent's will which provides for the setting up of trusts from the residue of the estate and stock of publicly held corporations make up the bulk of the estate left by the decedent. In this situation the executor may wish, well before the completion of administration, to make substantial distributions of securities to the residuary trustees so as to permit them to assume at an early date the long-range investment responsibility that is properly theirs. The executor should have a completely free hand in deciding the timing of such a distribution without regard to his decisions as to the accumulation or distribution of income, for decisions as to the timing of income distributions are governed by considerations having to do with making proper provision for meeting expenses and liabilities chargeable to income—considerations that are not relevant to the timing of corpus distributions.

Indeed, by failing to include securities and other intangible personal property within the exclusion of new section 663(a)(2), the present bill would encourage executors to refrain from making partial distributions long regarded as being in the interest of sound estate administration. In end result this will in many cases not be to the Government's interest.

It would be a mistake to assume that the extension of the separate share rule to estates contained in section 108(b)(1) of the bill (amending sec. 663(c) of the code) will correct the inequities with which we are concerned. That amendment is necessary to prevent a beneficiary from being taxed upon a share of the income of the estate which has no relation to the share of the estate left him by the decedent. It does not prevent a beneficiary from being taxed on income of the estate not distributed to the beneficiary but retained by the executor to cover expenses and liabilities.

In summary, the tax law should not, in effect, require that an executor refrain from acting in the best interests of the estate, unless there are compelling tax reasons for such a requirement. In view of the pro-

tection against abuse afforded by the requirement that the distribution must be made within 36 months after the death of the decedent and must consist of property held by the decedent at death, there is no need for a further requirement limiting the type of property that may be distributed. Section 108(a) of the bill should be expanded to cover distributions of intangible property as well as distributions of tangible property.

Senator BENNETT. Mr. Chairman, may I ask a question at this point?

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Do you agree with the earlier witness that simply the elimination of the word "tangible" would accomplish the purpose?

Mr. WOODFORD. In the interest of expediting what we regard as necessary changes to ease the administration of the law and bring some certainty out of the chaos that was created by this oversight in the 1954 code, we think the insertion of the word "intangible" would go a long way toward that end. I think we do, however, prefer the original advisory group approach, if this committee sees fit to make that change.

Does that answer your question, sir?

Senator BENNETT. Yes.

Mr. WOODFORD. Thank you.

The other proposed amendment that we believe to be in need of reconsideration is the multiple trust provision in section 113 of the bill.

Under existing law the creation by the same grantor of a number of trusts all accumulating income for ultimate distribution to the same beneficiary may be employed as a taxsaving device since income spread over a number of separate taxpayers is subject to a lower effective tax rate than if it were included in the return of one taxpayer. The extent to which this has been used as an avoidance device is a matter of conjecture.

I might say, within the last couple of weeks within our own institution, to reiterate what Mr. Farrier mentioned here about his bank, the First National of Chicago, in our smaller institution we have taken a look at this thing and out of possibly 400 active trust accounts, that is, trusts created by will and trusts created by agreement, we only have at the outside 5 trusts that could possibly come within this accumulation provision. I did not have time to go into those situations but I would venture to suggest that even in those situations where the income is being accumulated, in those five cases, there is no particular amount of tax involved.

Nevertheless, there has for some time been sentiment for the enactment of legislation to eliminate the tax advantages resulting from multiple trusts. And I might add, up until this morning when we saw the statistics mentioned by Mr. Farrier, the Treasury has never come forward with anything indicating the scope or magnitude of this problem. We have heard a lot about it. It is like a basket of apples, if there is one bad one in it, you do not throw all of them away. [Laughter.]

Section 113 contains a series of rather complex provision which may be operative whenever the same grantor creates more than one trust for the same beneficiary. Specifically, the section applies if two or more trusts accumulate income and in a year subsequent to the accumu-

lation make distributions to the beneficiary in excess of the current income for such subsequent year. In this case the excess distributions, other than those of the first trust to make such distributions, are under the multiple-trust rule, taxable to the beneficiary to the extent that the distributing trust has accumulated income at any time during the 10 years prior to the year of distribution. To compute the tax imposed on the excess distribution, the beneficiary must determine what his additional tax liability would have been in the earlier years in which the accumulated income was received by the trust on the assumption that such income had been distributed to him in such earlier years.

That is at best a very general and to say the least oversimplified description of the multiple-trust provision; there are many detailed requirements that further complicate the rule but that need not be explored for present purposes. It is sufficient to emphasize that the proposed rules are extremely complex and that they place a very heavy administrative burden on trustees, particularly on trust institutions that serve as trustee for many trusts.

Under given circumstances you have to go back and examine documents, records, and other information that may have been destroyed, going back as far as 1954 in order to determine whether you had a primary trust, which would bring these rules into operation.

We do not mean to suggest that there is a simple solution to the multiple-trust problem. But because of the complexities inherent in any multiple-trust provision, we do suggest that the thrust of the provision should be directed towards the abuse situation, the situation where multiple trusts have been created for tax avoidance purposes—they did that in 1937 in the case of foreign personal holding companies—and that an attempt should be made to avoid the imposition of additional burdens in cases where there is little, if any, likelihood that trusts have been created for tax avoidance purposes.

Thus, as an example, the legislation should take into account the fact that a grantor may create a trust for a beneficiary and after an interval of time find that, as a result of changes either in his position or in that of the beneficiary, the terms of the trust are no longer appropriate. Goodness knows how many different cases have come down in the meantime to make you decide to use different language in creating the new irrevocable trust. You created one trust and then there is a Supreme Court decision in the case of one named Clifford and you have to change the thing, so you would not dare to add to the same trust. Hence a new trust is created that will not run afoul of the new rules of the road. So these things make or may make the terms of an earlier trust no longer appropriate to use for this new gift. The grantor may then find it necessary to create a new trust if he intends to make further transfers for the benefit of the same beneficiary.

The proposed amendment in section 113 of the bill makes no allowance for this possibility; instead it applies the multiple-trust rules whenever a grantor creates more than one trust for the same beneficiary, regardless of the interval of time between the creation of the trusts or the circumstances under which they were created.

In this respect we think the proposal is far too rigid. We suggest that it be changed to provide that the multiple-trust rule will not

apply where the grantor creates only two trusts and a designated period of time separates the creation of the first trust from the creation of the second. Opinions will differ as to what constitutes a reasonable period of time; however, we think something in the neighborhood of 3 to 5 years would be appropriate. We do not maintain that this would in every case draw a precise line between the bona fide and the tax avoidance situation. But we do submit that with such a rule the multiple-trust provision will still serve as a formidable deterrent against tax avoidance schemes without subjecting to the complexities of the multiple-trust rules many bona fide cases that are not motivated by considerations of tax avoidance.

With the same objective in mind, we recommend that lifetime and testamentary trusts be considered separately in determining whether a multiple-trust situation exists. Clearly, the creation by a grantor of a trust during his life and another trust under his will rarely, if ever, is motivated by tax considerations. Indeed, when the grantor of an inter vivos or living trust wishes to transfer additional property to the trust by his will, the normal practice is to create a new and separate trust under the will, for in many States additions by will to an inter vivos trust are of doubtful validity or are not permissible.

The bill has not adequately dealt with this problem. Proposed section 669(b)(3)(A) provides that a multiple-trust situation arises only if there are "two or more trusts to which the same person contributed property." Under section 7701 of the code, the term "person" is defined as including an estate. This leaves in doubt the question as to whether a testamentary trust is to be deemed to have been created by the decedent or by a person other than the decedent for the purpose of the multiple-trust provisions. The House Ways and Means Committee report is silent on this question.

We believe that it should be made clear in the statute that for purposes of the multiple-trust rule lifetime trusts are to be treated separately from testamentary trusts, and the committee report should specifically refer to this point.

In addition to our concern as to the general scope of the multiple-trust rule, we believe there are several shortcomings in the technical details of this provision which will produce serious inequities, if not corrected.

The provision requires that if distributions in excess of current incomes are made to the same person by more than one trust created by the same grantor, then all distributions other than those from the first trust to make an excess distribution are subject to the multiple-trust provisions. In determining which trust is the first to make an excess distribution—referred to as the "primary trust"—all distributions made subsequent to 1953 must be taken into account. Thus an excess distribution made as long ago as 6 years prior to the enactment of this bill may create a primary trust, and that is where I mentioned earlier that that would impose a tremendous administrative burden on trustees. Even if you only had one trust per person now and you made an excess distribution, you would have to go back and make a search to see if there had existed since 1953 a trust for that same person that had terminated, at least one that was within your knowledge.

This retroactive feature of the proposal may produce extremely unfair results. For under the multiple-trust provision substantial differences in treatment may result depending on which of two trusts is considered the primary trust, since distributions from all trusts other than the primary trust will be subject to the very stringent multiple-trust distribution rules. Thus, for example, if the two trusts differ in size, it would be disadvantageous to the beneficiary if the first excess distribution were made from the smaller trust, because, in that event, the larger trust would become subject to the complex multiple distribution rules.

If no excess distributions are made prior to the enactment of this bill, the beneficiary's interest may be protected by making any such distributions from the larger trust first; however, if an excess distribution were made from the smaller trust after 1953 and prior to the date of enactment, then, under the proposal, the beneficiary would forever be bound by it even though he had no knowledge of the multiple-trust rule at the time of the distribution. The net effect is to impose an arbitrary penalty on the beneficiary of a trust that makes excess distributions during the period from 1954 through 1959, since such distributions necessarily were made in ignorance of the adverse consequences attached to them.

In addition to its discriminatory effect on some beneficiaries, this retroactive provision imposes an unreasonable burden on trustees in that it requires them to examine trust distributions for the past 6 years, back through 1954, as I mentioned before, to determine whether accumulation distributions have been made. In appreciating the magnitude of the problem that this will create, it must be remembered that many trust companies act as trustee for hundreds or even thousands of different trusts.

For these reasons, we would consider it important to eliminate this retroactive feature of the multiple-trust proposal and suggest that the definition of a primary trust be amended to make it clear that excess distributions are to be taken into account only if made after the date of enactment of the bill.

Our next recommendation concerns proposed section 669(a)(3). This provision requires that if a beneficiary receives a distribution that is subject to the multiple-trust rules, it will be treated as taxable income to him regardless of the character of the accumulated income when received by the trust.

Thus, for example, even if it can be shown that the accumulated income consists of tax-exempt interest, on State or municipal bonds or other tax-exempt bonds, it will be treated as taxable income when distributed to the beneficiary. This adds a penal feature to the multiple-trust provisions that is without justification and that, insofar as it applies to tax-exempt interest from State and local obligations, is of doubtful constitutionality. Clearly, the provisions in section 669(a)(3) should be deleted.

Finally, we wish to call to your attention the need for a technical change in section 669(b)(2) that we would presume to be noncontroversial and that was probably overlooked in the House bill. Under the proposal, a trust may make a distribution which technically qualifies as a multiple-trust distribution even though it is not in excess of current income. This could result if the trust incurred corpus

expenses which reduce distributable net income for tax purposes but which, under trust accounting principles, do not reduce the amount of current income distributable by the trust.

Clearly, there is no reason to invoke the multiple-trust rules unless distributions exceed income both as determined for trust accounting purposes and as determined for Federal tax purposes. The law should provide that an accumulation distribution occurs only if the distribution is in excess of both trust income and distributable net income. A similar change should also be made in section 665(b) of the code to cover the same point which was evidently overlooked in the drafting of the 1954 Code.

We appreciate the opportunity to present our views on these matters to your committee.

The CHAIRMAN. Thank you very much, Mr. Woodford.

The next witness is Mr. James B. Lewis, Association of the Bar of the City of New York.

Mr. Lewis, take a seat, sir, and proceed.

STATEMENT OF JAMES B. LEWIS, ON BEHALF OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

Mr. LEWIS. Mr. Chairman, I am James B. Lewis, a practicing attorney in New York City, and I appear here as chairman of the Committee on Taxation of the Association of the Bar of the City of New York.

Our committee believes and recommends that H.R. 9662 should not be enacted into law. Instead we respectfully suggest that action on this measure be deferred pending further study and the development of a line of judicial and administrative decisions under present law to establish its strengths and its weaknesses.

This bill would make numerous revisions in the provisions of the income tax law relating to estates and trusts and their beneficiaries, and to partnerships and their partners. It is addressed to a very complicated and highly technical set of provisions which have been in our tax law for less than 6 years. To a very real extent, the Internal Revenue Service and tax practitioners are still in the process of learning and exploring the meaning of these provisions and the problems they present. Up to this point the flow of administrative decisions has not yet reached into all of the important areas of the statute while judicial interpretations hardly exist.

We already have sufficient experience with the present statute to know that it is not perfect, but we also know that it does not cry aloud for change. In short, we are not convinced that the changes proposed in the bill are so significant, or that the problems supposed to be resolved by it are so serious, as to make the proposed legislation mandatory or even urgent.

The unending stream of legislation revising the tax laws places a great burden on the Internal Revenue Service and tax practitioners alike. Regulations under highly significant provisions of the 1954 law have not yet been published. Adding to the present statute for the purpose of effecting technical improvements at the point is justifiable only if absolutely necessary.

In many areas, and particularly the areas with which this bill deals, the importance of having a well-established rule is much greater than the question of what the rule should be. Yet the proposed bill would make many, many changes in precisely those areas.

Other proposed changes, a lesser number in the bill, purport on the one hand to mitigate unintended hardships, and on the other to reduce possibilities for tax avoidance, and with many of these we do not disagree. We know, however, from experience that technical amendments with such laudable objectives as these may create two or even more new problems for every old one that they appear on the surface to resolve.

For these reasons, we think that enactment of this bill at this time would be unwise. To support this position and to assist yourselves and your staff to study the bill, we have prepared a section-by-section analysis of the more troublesome sections. I respectfully request that this analysis be made a part of the record of these hearings, but I do not propose to read it to you this morning. Instead I should like to state in two or three sentences what it does not do and what it does do.

The CHAIRMAN. The insertion will be made.

Mr. LEWIS. First, it does not enter into questions that we consider to be questions of policy for your committee to resolve. Unlike some of the other groups that have appeared, we have deliberately refrained from taking a position on whether you should act with respect to multiple trusts, and whether you should act with respect to charitable distributions.

We do, however, enter fully, and I think objectively, into a discussion of the technical aspects of the bill, a discussion of the provisions which I feel tax practitioners can peculiarly bring a competence to.

For this reason, I respectfully request that your staff study our statement carefully and, finally, I respectfully urge that this bill not be reported until the technical problems raised by us can be dealt with in a thoughtful and effective manner.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Lewis.

(The prepared statement submitted by the Association of the Bar of the City of New York follows:)

STATEMENT OF JAMES B. LEWIS, CHAIRMAN, COMMITTEE ON TAXATION, THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

My name is James B. Lewis. I live in New York, N.Y., and I am an attorney at law. I appear in my capacity as chairman of the Committee on Taxation of the Association of the Bar of the City of New York.

Our committee believes and recommends that H.R. 9662 should not be enacted into law. Instead, we respectfully suggest that action on this measure be deferred pending further study and the development of a line of judicial and administrative decisions under present law to establish its strengths and weaknesses.

H.R. 9662 would make numerous revisions in the provisions of the Internal Revenue Code of 1954 relating to estates and trusts and their beneficiaries, and partnerships and their partners. The bill is thus addressed to a very complicated and highly technical set of provisions, which have been in our tax laws for less than 6 years. To a very real extent the Internal Revenue Service and tax practitioners are still in the process of learning and exploring the meaning of these provisions and the problems they present. And up to this

point the flow of administrative decisions has not yet reached into all of the important areas of the statute, while judicial interpretations hardly exist.

We already have sufficient experience with the present statute to know that it is not perfect. But we also know that it does not cry aloud for change. In short, we are not convinced that the changes proposed in H.R. 9662 are so significant, or that the problems supposed to be resolved by it are so serious, as to make the proposed legislation mandatory.

The unending stream of legislation revising the tax laws places a great burden on the Internal Revenue Service and tax practitioners alike. Adding to it for the purpose of effecting technical improvements is justifiable only when absolutely necessary. In many areas the importance of having a well-established rule is much greater than the question of what the rule should be; yet the proposed bill would make many changes in precisely these areas. Other proposed changes purport, on the one hand, to mitigate unintended hardships and, on the other, to reduce possibilities for tax avoidance; yet experience has repeatedly shown that technical amendments with such laudable objectives may create two or more new problems for each old one resolved. For these reasons we think that enactment of H.R. 9662 at this time would be unwise.

In support of our position and to assist your committee and its staff in studying the bill, we have prepared an analysis of the more troublesome sections.

TITLE I—ESTATES AND TRUSTS

Section 641(c).[1] *Legal life estates and other terminable legal interests*

This section is added to make certain that a tax will be payable on capital gain resulting from the sale of property in which someone owns a legal life estate. Court decisions raise the possibility that such capital gain will escape tax in some jurisdictions in certain circumstances for lack of an identifiable taxpayer.

The bill would deal with this problem by deeming a trust to exist in a calendar year in which there is gross income attributable to property subject to the life estate and not otherwise subject to tax; the trust would be deemed to exist with respect to all such gross income. The section carries out recommendations which we made in 1954 and 1955. However, as drafted, it raises several technical problems. First, it is not clear whether the trust would be deemed to continue from year to year. Secondly, the bill does not specify the tax result sustained on the sale of property at a loss. Thirdly, the bill may create more than one trust where more than one property is held subject to a legal life estate.

It is doubtful whether gross income of the type described should be subject to tax, yet the section as written may so provide. Possibly, on sales of property subject to a life estate some sales would result in gains and others in losses in the same or a different calendar year. It should be made clear that the deemed trust would be subject to tax only on taxable income after deduction of losses and expenses and that it would be entitled to the benefit of the loss carryover provisions.

The section is also susceptible of the interpretation that the income from the sale is taxable even though the application of other provisions of the code relating, for example, to charitable organizations might otherwise result in no tax on such income.

An approach which might avoid some of these difficulties would be to broaden the definition of a trust to include property subject to a legal tenancy, thus subjecting the property to the general trust requirements. A relief provision could be enacted to prevent filing of returns in years when no income which would otherwise escape tax was received.

Section 642(a)(3). Dividends received by individuals

The amendment to this section is intended to permit the trust the $50 dividend exclusion under section 116(a), if it retains dividend income of the type subject to the exclusion up to a maximum of $50, without the requirement of proration. The amendment would permit the dividend exclusion to be taken only in respect of so much of such dividends as is not properly allocable to any beneficiary under section 652 or 662. This language does not seem any clearer than present law. We suggest that proration be clearly negated by providing that the dividend exclusion of the estate or trust be not in excess of $50 or such

[1] Section references, unless otherwise identified, are to the Internal Revenue Code of 1954 as proposed to be amended by the bill.

lesser amount of dividends as is not properly paid, credited, or required to be distributed to any beneficiary.

Section 651. Deduction for trusts distributing current income only

The deduction permitted by proposed section 651(a) is the amount of the income for the taxable year which is required to be distributed currently, that is, the amount of income determined under the trust instrument or applicable local law, including tax-exempt income. Thus, a trust with $50,000 of taxable income and $50,000 of tax-exempt income would be permitted to deduct $100,000 under proposed section 651(a).

Proposed section 651(b) is designed to limit the deduction of the trust in the above case to $50,000, the amount of distributable net income. The deduction limitation of proposed section 651(b) applies only if the amount of income required to be distributed currently exceeds the distributable net income. The proposed section provides, however, that for purposes of this calculation tax-exempt income is excluded from distributable net income and income required to be distributed currently. Consequently, under proposed section 651(b) distributable net income and income required to be distributed currently in the above example would each equal $50,000, the deduction limitation would not apply and the trust would be entitled to deduct $100,000. This is clearly an unintended result and is caused by the exclusion of tax-exempt income from income required to be distributed currently in proposed section 651(b).

Since the proposed amendment of section 651(b) is designed to make it clear that the deduction limitation under section 651(b) is the same as that arrived at under 661(c), it is suggested that the language of section 661(c) be adopted and used.

Sections 652(c) and 662(c). Different taxable years

Under the proposed revision of subsection (c) of section 652 and of section 662, the amount of income that may have to be included in the final return of a deceased beneficiary whose normal taxable year was different from that of the trust or estate may be increased substantially as compared with present law.

Present regulations specify how trust or estate income required to be distributed shall be taxed in the taxable year of the trust in which a beneficiary who is on the cash basis dies. The trust or estate income which was not actually distributed to the beneficiary prior to his death is included in the gross income of his estate, as income in respect of a decedent, rather than in his final return. This rule was introduced under the 1954 Code to prevent the bunching of as much as 23 months of trust or estate income in a beneficiary's final return and thus subjecting it to unusually high tax rates.

However, proposed sections 652(c) and 662(c) would require that the amount to be included in the final return of the deceased beneficiary be based upon the amount of income of the trust or estate from the end of its last preceding taxable year to the date of the beneficiary's death. Thus, where the normal taxable years of a trust or estate and its beneficiary are different, the revised subsections could bunch as much as 23 months of income in the final return of the beneficiary upon his death. Our committee does not view this as an improvement over present law. If any change is to be made, we suggest that it be limited to cases in which the normal taxable years of the trust or estate and the beneficiary are the same. As a last resort, the revised subsections might be limited to situations in which application thereof would not result in the inclusion of more than, say, 16 months of income of a trust or estate in the final return of a deceased beneficiary.

Sections 661(a) and 662(a). Deduction and inclusion: the "four tier" system

Under present law, beneficiaries of estates and trusts are divided into two classes or tiers for the purpose of determining which of them are taxable upon the income of the estate or trust. The bill proposes substitution of a four-tier for a two-tier system to determine the taxability of trust income. Moreover, the bill would bring charitable beneficiaries within the tier system, instead of providing a separate charitable deduction.

Under present law, charitable distributions are, in effect, placed in a separate category between tier one, income required to be distributed currently, and tier two, all other amounts properly paid, credited, or required to be distributed. The result of this in some cases has been to reduce the tax liabilities of noncharitable beneficiaries receiving tier two distributions. For example, under present law, if a trust with gross income of $10,000 is required to distribute all

income to a charity and an equivalent amount from corpus to a noncharitable beneficiary, no part of the trust's income is taxable.

Under proposed sections 661(a) and 662(a), charitable distributions would constitute the last tier of a four-tier system. The result of this would be that charitable distributions, whether out of income or corpus, could never reduce the distributable net income allocable to noncharitable beneficiaries. In the example given in the preceding paragraph, the noncharitable beneficiary would be taxable on the entire $10,000 of the trust's gross income.

Our committee, believing this proposed change in the law with respect to charitabl distributions to be a question of policy, takes no position upon it. Apart from the charitable feature, we do not regard the four-tier system as significantly better or worse than present law, and we wonder whether you should adopt changes which, although theoretically complex, produce no really significant new results. Finally, if the proposed four-tier system is to be enacted, we make the following technical recommendations:

(1) In paragraph (3) of both section 661(a) and 662(a) the word "properly" appears before "paid or credited, or required to be distributed," whereas "properly" does not appear in paragraphs (1), (2) and (4) of section 661(a) or paragraphs (1) and (2) of section 662(a). If the word "properly" has any significance in the two paragraphs (3), it seems that the term should also be included in these other paragraphs. If the word "properly" has no significance, it should be deleted.

(2) In order to conform paragraph (4) of proposed section 661(a) to paragraphs (1), (2) and (3), it is suggested that paragraph (4) be changed to read as follows:

> "(4) any amount which, pursuant to the terms of the governing instrument, is paid, *credited, required to be distributed*, or permanently set aside during the taxable year for a charitable beneficiary * * *." [Suggested new matter italicized.]

Section 663(a). Exclusions: Gifts, bequests, etc.

Certain distributions by estates or trusts do not shift income tax liability from the estate or trust to the beneficiary. Under present law, this "excluded category" consists of gifts or bequests of specific sums of money or specific property. Moreover, this exclusion is available to estates, testamentary trusts and inter vivos trusts. Proposed section 663(a) denies the exclusion to most inter vivos trusts. The reason for this treatment of most inter vivos trusts is not given in the report of the House Committee on Ways and Means, and we are not sure what the reason is. At the very least, the reason for eliminating most inter vivos trusts should be made clear.

Moreover, we are puzzled as to the classification of inter vivos trusts under this provision of the bill. It would retain the exclusion only for those inter vivos trusts which are revocable by the grantor acting alone. The House report justifies this on the ground that such trusts are testamentary in character. However, this observation may also be made with respect to other types of trusts which are includible in the grantor's gross estate for estate tax purposes. We think, therefore, that the proposed classification should be reexamined.

We also feel that the proposed section 663(a) is faulty in limiting the exclusion to amounts "distributed" by an estate or trust. The tests for deductibility under proposed section 661(a) and for taxability under proposed section 662(a) are not for amounts "distributed," but for amounts "paid, credited, or required to be distributed." We think that the test for exclusion under proposed section 663(a) should be similarly phrased, to conform to proposed sections 661(a) and 662(a). Also, the comment on the word "properly" under proposed sections 661(a) and 662(a) is applicable here.

Section 663(d). Required distribution to another trust

This is a new provision, designed to produce a more equitable result where a portion of an existing trust is distributed to another trust, for example, to provide for a newly-born child. In one situation, the provision seems to produce an unintended result. If the distribution takes place on the last day of the taxable year of both the distributing trust and the receiving trust, the distributing trust is entitled to an immediate deduction but the receiving trust is not required to include the distribution in its income until its first taxable year which ends after the date of the distribution, which would be the suceeding

year. To avoid this odd result, we suggest that the second sentence of proposed section 663(d) be changed to read as follows:

"The receiving trust shall include in its gross income for its first taxable year which ends *on or* after the date of the distribution an amount equal to the amount described in paragraph (3)." [Proposed new matter italicized.]

Section 664. Power in person other than grantor to vest corpus or income in himself

This section, which replaces the present section 678, would treat as a trust beneficiary a person other than the grantor who has a power to vest trust income or corpus in himself. Under subsection (a)(2), such a power over corpus would cause the income attributable to the corpus to be regarded as income "required to be distributed currently," that is, as a "tier one" distribution. However, this treatment would be limited to income attributable to that portion of the taxable year beginning with the day on which the power may be exercised and ending on the day it is exercised. While this seems correct with respect to a power exercisable throughout the year, it would seem to provide an opportunity for avoidance through creation of a power over corpus exercisable only on a specified day or during a few specified days of the taxable year.

Section 664(c) continues the exception, found in section 678(c) of the existing law, for cases where the power in question is one to apply income to the support or maintenance of a person whom the holder of the power is obligated to support and which power is exercisable by the holder in the capacity of trustee or cotrustee. In such case the old section 678(c) and the new section 664(c) make the rules of the respective sections applicable only when and to the extent that the income is actually so applied. The mere existence of such a power will not make the sections operative.

However, section 664 covers both powers over income and powers over corpus. If powers over income limited to support and maintenance are to receive special treatment, it would seem that section 664(c) should also except from the general operation of the section a fiduciary power to apply corpus to support and maintenance. It is as appropriate in one case as the other that taxation should depend on actual application and not on the existence of the power.

Also, in view of the fact that the holder of such a power is generally considered to be a fiduciary, even though not technically a trustee or cotrustee, consideration might be given to enlarging the exception to cover any case in which the power is exercisable in a fiduciary capacity.

Section 665(b). Accumulation distribution: The "throwback" rule

Proposed section 665(b)(5) would add an exception to the operation of the "throwback" rule, which taxes to trust beneficiaries certain distributions of income accumulated by the trust in prior taxable years. This new exception covers final distributions made, by reason of a beneficiary's attainment of a specified age, from a testamentary trust or an inter vivos trust which, immediately before the grantor's death, was revocable by him acting alone.

The reason for restricting this exception to such a narrow range of inter vivos trusts is obscure. The report of the Committee on Ways and Means refers only to a desire to prevent application of the "throwback" rules simply by reason of the date of the grantor's death. Since this date would have relevance in the case of any inter vivos trust of which the grantor is treated as owner, the exception would seem equally justified in the case of all such trusts. We accordingly recommend its extension thereto.

Section 669. Multiple trusts

We seriously question the proposed solution for the multiple-trust problem. It is our view that in eliminating the tax avoidance possibilities of the device Congress should impose no greater taxes upon beneficiaries than those to which they would be subjected if receiving their entire incomes currently from single trusts. Thus, for example, we object to making section 662(b) (the character rule) inapplicable in the case of multiple-trust distributions. By eliminating this rule, the bill would apparently subject to tax at ordinary rates capital gains, tax-exempt interest, and other generally favored types of income. There seems no reason for subjecting capital gains, for example, to a higher rate of tax or for taxing otherwise exempt income when these items are deemed to have been distributions from one of several trusts for the same beneficiary than under other circumstances.

We also disapprove the change, for the purpose of multiple-trust distributions, in the language of section 668(a) which limits the beneficiary's tax. It would seem that distributions of accumulated income which would be treated as prescribed by the throwback rules if paid from a single trust should not be more rigorously treated if paid to the same beneficiary from several trusts.

TITLE II PARTNERS AND PARTNERSHIPS

Section 702(b). Character of items constituting distributive share

The conduit principle of present law for determining the items which make up the distributive shares of the individual partners is generally preserved and expanded. However, the statute is at the same time amended to provide that each item is to be considered as though realized or incurred directly by the partner and that in making any such determination, "due regard shall be given to any business, financial operation, or venture in which the partnership is engaged."

The report of the House Committee on Ways and Means states the intention that a share of gain may be capital as to one partner and ordinary as to another according to the circumstances of each. The Committee on Ways and Means believes that "a rule of this general type is essential to prevent serious tax avoidance since dealers might otherwise avoid ordinary income tax by combining in partnerships with nondealer partners."

We respectfully question whether prevention of tax avoidance requires this departure from the general rule under which the character of items is determined at the partnership level. In most instances, it would seem that where the intentions of a dealer partner with respect to partnership property are such as would prevent him from realizing capital gain upon its sale, proof of such intentions and the extent of the dealer partner's control over the affairs of the partnership would support a finding that the property in question was not a capital asset in the hands of the partnership. The risk of tax avoidance would not seem to justify the confusion which will result from the possibility that one partner's share may be treated differently from another's share of the same item. See also the comments under section 751.

Section 703(b). Deduction of organizational expenses of partnership

We believe that the expenses of organizing and reorganizing a partnership should be deductible when paid or incurred as ordinary and necessary business expenses and neither capitalized nor amortized. The loss of revenue involved would seem slight compared with the additional recordkeeping requirements and the difficulty of distinguishing between expenses of organization (which under the House bill are to be amortized) and expenses of revisions (which must be capitalized). Furthermore, in the case of small partnerships at least, it seems not unlikely that organization expenses which are not claimed and allowed when paid or incurred will be overlooked in the year of dissolution and thus permanently lost as deductions.

Section 735. Character of gain or loss on disposition of distributed section 751 assets

The rule provided by this section would operate more harshly against a partner than against an individual proprietor or corporate transferee in two respects. First, if assets held by a partnership primarily for sale are distributed in kind to a partner, gain realized from their sale by the distributee partner would be perpetually characterized as ordinary income regardless of any change in the purpose for which he holds the assets. Secondly, the purposes for which the distributed assets are held by a transferee of the distributee partner whose basis is determined by reference to the basis of the property in the hands of the transferor would not be relevant.

We believe that the character of distributed assets should be determined by reference to all the circumstances existing up to the time of their subsequent sale. This would not preclude consideration of the activities of the partnership and the extent of the participation therein by the distributee partner.

Section 750. Distributions which result in ordinary income

In general, the proposed section 750 would treat as a sale by or to the partnership of "substantially appreciated section 751 assets" distributions of property (including money) which affect the proportionate interests of the partners in such assets. Section 750(b)(3) provides that the rule of section 750 is not

to apply to a distribution of a partner's distributive share of the partnership income for the current year. We do not believe that there should be any such exception in the case of a distribution of section 751 assets (described in sec. 750(a)(1)) as opposed to a distribution of money or other assets (described in sec. 750(a)(2)).

Section 751. Definitions of section 751 assets and substantially appreciated section 751 assets

For reasons already stated with respect to section 702(b), we do not think it desirable or necessary to make the determination of whether property constitutes "section 751 assets" at the partner level as opposed to the partnership level.

Section 751(c)(1) contains rules for applying the tests to determine whether assets are section 751 assets. That paragraph purports to deal with sales of a partner's interest (covered by section 749) as well as distributions which change his proportionate interest in section 751 assets (covered by sec. 750). However, the clause "as if all property treated as sold or exchanged were sold directly by the person (or persons) relinquishing an interest in the property" seems appropriate only to distributions, for only under section 750 is any property "treated as sold or exchanged." In the event of a sale of an interest in the partnership, section 749 requires the proceeds of sale to the extent attributable to substantially appreciated section 751 assets to be considered as realized from the sale of property other than a capital asset.

If it is determined (contrary to the views expressed herein) that section 751 assets which are distributed in kind to a partner should, under section 735, retain perpetually their characterization as such, section 751(c)(1) should also be expanded to include language which will tie in to section 735.

Section 751(d) of the bill provides that section 751 assets are "substantially appreciated section 751 assets" if their fair market value exceeds (1) 120 percent of the adjusted basis to the partnership of such assets and (2) 10 percent of the fair market value of all partnership property other than money reduced by the liabilities of the partnership. Existing law makes no provision for deducting liabilities in applying the 10 percent test. In the light of this change and the broader definition of section 751 assets, consideration might be given to liberalizing the second test to provide for a larger percentage of net property. It is doubtful whether there are many instances where section 751 assets do not constitute more than 10 percent of net property. Under section 341(c)(1)(A), the presumption of corporate collapsibility does not arise unless section 341 assets are 50 percent of total assets including money and without deduction of liabilities.

Section 763. Alternative rule for determination of basis of partner's interest

Sections 722 and 742 of the bill should each be amended to include the words "For purpose of section 763," at the beginning, for both are properly applicable only to that alternative-basis rule as distinguished from the general rule of section 705(a).

Consideration might be given to the desirability of amending section 770(b)(1) to include expenses described in section 212.

Section 770. Interest in partnership capital exchanged for services

We do not believe it desirable to insert in the law a long and complicated new provision governing the taxability of compensation in so limited an area as that involving transfers of interests in partnership capital. Existing law seems adequate to cover this situation. The proposed section 770 would, we feel, create new problems and uncertainties.

Section 776(a). Amounts to be paid to a retired partner or a deceased partner's successor in interest: Amounts considered as distributive shares or guaranteed payments

The bill retains the basic division of present law between payments made to a retiring partner or a deceased partner's successor in interest for the ex-partner's "interest in partnership property" and payments in excess of such interest. Payments made in excess of the ex-partner's "interest in partnership property" continue to be divided under subsection (a) between the portion thereof determined "with regard to the income of the partnership," which is treated as a distributive share of partnership income, and the portion not so determined, which is treated as a guaranteed payment."

The proposed statutory provision differs in substance from the existing provision by providing that any payment falling within the provisions of subsection (a) shall be treated as a "guaranteed payment," if not actually "paid or payable, on or before the 15th day of the fourth month following the close of the partnership's taxable year with respect to which such amount is determined."

This addition raises several questions. We respectfully submit that it is neither necessary nor desirable to shift payments out of a category which is treated as a distributive share of partnership income, a category having substantial historical precedent and fairly clear meaning, into the "guaranteed payment" category, a term first introduced in the 1954 Internal Revenue Code, and one which presents a considerable number of problems. The reason presented for the shift of the report of the House Committee on Ways and Means seems to be that retention of the special income characteristics of payments treated as distributive shares presents practical administrative problems. This is somewhat obscure and does not appear persuasive.

Further difficulty is presented by the new provisions contained in section 776(a)(2). This paragraph deals with the time amounts payable under subsection (a) are to be taken into account by the partnership and recipient. Determination of the time for inclusion of a partner's distributive share of partnership income has generally presented little difficulty. The provisions contained in section 776(a)(2)(A), therefore, appear unnecessary and, by substitution of a specific rule for the general rule, tend to create confusion where none existed before.

Subsection (a)(2)(B) states that a "guaranteed payment" shall for this purpose be taken into account as of "the last day of the partnership taxable year in which such amount was paid or payable." The term "paid or payable" is not unambiguous. Suppose, for example, that a retired partner is entitled to 10 percent of the partnership profits for the calendar year, with provision that payment shall be made on June 15 of the following year. Is the amount payable at the close of business on December 31, or is it payable only on the following June 15? Again, suppose an amount that qualifies as a section 776(a) payment is to be paid on or before June 30 of the year following that in which it becomes fixed, and that payment is made on April 1 the following year. In which year would the amount be includible in the income of the recipient? If includible for the year prior to payment, does the proposed provision, in effect, allow a partnership with a properly drawn agreement an annual election as to the year of deductibility of such payments?

The present regulations approach the question better by treating guaranteed payments as income to the recipient for his taxable year in which ends the partnership taxable year in which the payments are deducted by the partnership as paid or accrued under the partnership's method of accounting.

Although the House committee report indicates that the term "payable" is intended to relate to "accrual method taxpayers," the words "paid or payable," as used in the proposed section 776(a), tend to confuse rather than clarify the question of whether "payable" means accrued where an accrual basis partnership is involved or merely distributable at the option of a cash-basis partnership.

For the foregoing reasons, we believe that the change reflected in section 776(a)(1)(A)(ii) should not be made, and that section 776(a)(2) should be eliminated.

Section 776(c)(1). Same: Exception where all amounts are payable in 12-month period

This provision is new. If all amounts payable on liquidation of an interest in a partnership are payable within any 12-month period, no part of section 776 (a) or (b) would apply and such amounts would be treated simply as distributions by the partnership.

According to the report of the House Committee on Ways and Means, this provision was inserted to meet the "expectation" of most partners arranging for a limited number of liquidating payments. Whatever the expectation of most partners might be, it may be pointed out that current law permits any partner to secure a comparable result by merely providing for "payment for goodwill," subject to the requirement contained in the present regulations that such payments be "reasonable."

Since the hypothesis upon which this provision is based is speculative and its advantages do not appear substantial, it is suggested that the interests of

simplification and clarification of the partnership provisions might be served more significantly by the elimination of this provision than by its inclusion.
Dated: April 22, 1960.

Senator BENNETT. May I ask one question?

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Does the technical and detailed part of your presentation turn up any unusual problems that have not already been presented to us?

Mr. LEWIS. Yes, a great many such problems, Senator Bennett.

The CHAIRMAN. Thank you, sir.

The committee will now adjourn.

(By direction of the chairman, the following is made a part of the record:)

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
New York, N.Y., April 22, 1960.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
New Senate Office Building, Washington, D.C.

DEAR MR. BYRD: The following comments on H.R. 9662, Title I Estates and Trusts, are offered by the Committee on Federal Taxation of the American Institute of Certified Public Accountants.

Effective date

Section 121 of the bill makes most amendments effective as to taxable years ending after the date of enactment. It would be more equitable and would simplify administration of the laws if the bill were effective generally as to taxable years beginning on or after the date of enactment. This would be consistent with the effective date provided in section 204 of H.R. 9662 for changes in subchapter K.

The relatively short postponement of effective date would have little effect on the revenues and would allow taxpayers a breathing spell in which to determine the effect of new provisions. While many of the amendments in title I also appeared in the final report of the Advisory Group on Subchapter J, H.R. 9662 includes some significant changes which appear for the first time in the bill. It cannot be said that taxpayers have received adequate notice of such provisions of the bill as Section 669: Multiple Trusts, and Section 641(c): Legal Life Estates and Other Terminable Interests.

The postponement also would give the Treasury Department time to prepare regulations before the statutory changes become effective for many taxpayers. This would be extremely helpful, as it would reduce the likelihood that taxpayers be asked to take actions and report income in tax returns without full knowledge of the effect of such actions. This is particularly true in those cases where the statute states the effect of the amendment will be determined in accordance with regulations to be prescribed, as, for example, Section 663(c): Application of the Separate Shares Rule to Estates, and Section 669(c)(1): The Effect of the Multiple Trusts Rule on Two or More Persons Contributing to the Same Trust.

Final return of a beneficiary

Sections 652(c) and 662(c) as amended would, in the case of a beneficiary whose existence terminates, close the taxable year of a trust as to that beneficiary as of the date existence was terminated. In many cases, this would require the inclusion of more than 12 months income in the beneficiary's final return. For example, assume the trust files on a January 31 fiscal year and a beneficiary uses the calendar year. If the beneficiary dies after January 31, his final return would include not only his share of income for the year ended January 31 but also his share for the period from February 1 to the date of death. The resultant "bunching" of income can cause an inequitably high tax. Furthermore, this is inconsistent with changes proposed in other provisions of H.R. 9662 dealing with deceased partners.

When subchapter K was enacted in 1954, bunching in the case of partnerships was eliminated by keeping open the partnership year until its normal conclusion with the deceased partner's estate reporting the share of income for the period ending with date of death. However, as noted in the report of the Ways and

Means Committee on H.R. 9662 (p. 30), the elimination of bunching in the final return of a partner overlooks the fact that this may deny the opportunity to offset deductions against this income and the benefits of income splitting. Accordingly, title II of H.R. 9662 permits the successor in interest of a deceased partner an election to continue the partnership year to its normal close unless the interest is disposed of prior to that date.

In view of the similarity of problems, it would be more equitable to apply the same rule to deceased beneficiaries as that proposed for deceased partners.

Gifts and bequests of specific sums or specific property

The proposals for amendment of section 663 will eliminate many inequities in present law. However, we do not believe inter vivos trusts, in general, should be prevented from qualifying under section 663(a)(1) as amended. The bill would permit an exclusion for a gift under the terms of an inter vivos trust which is revocable by the grantor acting alone. The Committee on Ways and Means states that such trusts qualify because they are testamentary in character. For purposes of estate tax, any trust in which the grantor retains an interest is testamentary in character and includible in the estate. If, as a matter of policy, it is desirable to limit the exclusion to estates and trusts which are testamentary in fact or in character, it would be logical to permit the exclusion to apply to all inter vivos trusts which, because of retained interests, are included in the grantor's estate.

The problem also arises with respect to the proposed amendments of the throwback rules in section 665(b)(5). We recommend a similar correction of that paragraph.

Multiple trusts

The proposed treatment of multiple trusts would not present the difficulties attendant upon the combined trust proposal recommended by the Advisory Group on Subchapter J. An expanded throwback rule for distributions from multiple trusts may present other difficulties because the intricacy of the throwback rules causes administrative problems, and the postponement of tax may provide careful planners with opportunities for avoidance. Furthermore, the denial of the right by a beneficiary to retain the character of income passed to him through a trust appears inequitable and without purpose. However, within the existing framework of estate and trust income taxation, the throwback approach seems preferable.

We shall be available for any further discussions of the bill which may be desired by your committee or staff.

Respectfully submitted.

LESLIE MILLS,
General Chairman, Committee on Federal Taxation.
MAXWELL A. H. WAKELY,
Chairman, Subcommittee on Estates and Trusts.

U.S. SENATE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
April 25, 1960.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

MY DEAR MR. CHAIRMAN: As you know, Senator Bridges and I have introduced S. 2789, which changes the effective date of Public Law 86–376. This law amended subchapter S of the 1954 Code to cover situations where a shareholder (of a small business corporation electing to deduct their pro rata share of the corporation's net losses) dies before the end of the corporation's taxable year. The bill would make the change in the law retroactive to September 2, 1958, the date subchapter S was enacted.

Our interest in this matter is occasioned by the death of former New Hampshire Governor Francis Murphy. We believe his estate is entitled to the same tax treatment as the estate of persons dying after the effective date of the 1959 act.

It is our hope that this proposal can be considered by the committee as an amendment to H.R. 9662, which makes other technical changes in the tax laws. I am attaching a draft of such an amendment, and a brief explanatory statement.

Both the Treasury Department and Bureau of Budget have submitted their views on the bill. We believe the equities in our specific case, and in the very limited number of similar cases which would be affected, is sufficient to merit the careful attention of the committee, despite the general views of these agencies about retroactive application of changes.

With every good wish.

Yours sincerely,

NORRIS COTTON, *U.S. Senator.*

H.R. 9662, AMENDMENT INTENDED TO BE PROPOSED BY MR. COTTON (FOR HIMSELF AND MR. BRIDGES)

At the appropriate place, insert the following new section:

"SEC. - -. The second sentence of subsection (d) of section 2 of Public Law 86 376 is amended to read as follows: "The amendment made by subsection (b) shall take effect on September 2, 1958, and the amendment made by subsection (c) shall take effect on September 24, 1959."

BRIEF EXPLANATION OF S. 2789

In the Technical Amendments Act of 1958 the Congress enacted subchapter S, relating to small business corporations. Under these provisions a qualified small business corporation can elect to have its income taxed directly to its shareholders and to have its net operating losses passed through directly to its shareholders. As initially enacted in 1958, section 1374 allowed a shareholder of an electing small business corporation to deduct his pro rata share of the corporation's net operating loss for his taxable year in which or with which the taxable year of the corporation ends. However, a shareholder who died before the end of the corporation's taxable year was deprived of his share of the net operating loss which occurred in the corporation's taxable year in which he died because there was no taxable year of the corporation that ended with or within the abbreviated taxable year of the shareholder. Because of this, section 1374 was amended by section 2(b) of Public Law 86-376, 86th Congress, 1st session, to make it clear that in such a case a deceased shareholder will not be denied his pro rata share of the electing small business corporation's net operating loss. This amendment, however, was made effective only from the day after the date of the enactment of Public Law 86-376. This was September 24, 1959.

The purpose of the proposed amendment is to make the effective date of this particular provision of Public Law 86-376 September 2, 1958, the date of the original enactment of subchapter S, in order that shareholders of an electing small business corporation who died prior to September 24, 1959, are also not denied their pro rata share of the net operating loss of the electing small business corporation occurring in the year of the shareholder's death.

(Whereupon, at 11:55 a.m., the hearing was adjourned.)

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