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1. Cross-References within the Internal Revenue Code of 1954 as of January 1, 1961

2. Suggested Methods of Liberalizing Depreciation

3. Refunds and Credits of Internal Revenue Taxes for the Fiscal Year Ended June 30, 1959

4. Comparison of Existing Law with President's Proposals on Taxation of Income from Foreign Subsidiaries

5. Digest of Testimony Presented and Statements Submitted to the Committee on Ways and Means with Respect to the President's Tax Recommendations

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11. Report on the Renegotiation Act of 1951 (H. Doc. 322)

12. Cross-References within the Internal Revenue Code of 1954 as of Jan. 1, 1962

13. Summary of the Revenue Bill of 1962 As It Passed the House (H.R. 10650)

14. Digest of Testimony Presented and Statements Submitted to the Committee on Finance with Respect to H. R. 10650

15. (Conf.) Supplemental Digest of Testimony Presented and Statements Submitted to the Committee on Finance with Respect to Foreign Income Tax Sections of H. R. 10650

16. Analysis of Section 19 of H. R. 10650 Withholding on Dividends and Interest

17. (Conf.) Suggestions for Amendments to H. R. 10650

18. Summary of Revenue Bill of 1962 As Reported by the Senate Committee on Finance (H. R. 10650)

19. Summary of Senate Amendments to H. R. 10650

20. Summary of the Provisions of the Self-Employed Individuals Tax Retirement Act of 1962 (H. R. 10)

GENERAL EXPLANATION
OF
COMMITTEE DISCUSSION DRAFT OF
REVENUE BILL OF 1961

Released for Information and Study, August 24, 1961

PREPARED FOR THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

NOTE.—This document has been printed for information purposes only. It has not been considered or approved by the committee or any member thereof.

SEPTEMBER 29, 1961

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GENERAL EXPLANATION OF COMMITTEE DISCUSSION DRAFT OF REVENUE BILL OF 1961

I. INTRODUCTORY STATEMENT

On April 20, 1961, the President sent to Congress a message containing a series of proposals for the revision of certain of the present tax laws. The Committee on Ways and Means on May 3, 1961, began hearings on the President's proposals. In these hearings, which extended over a month, the committee received testimony and comments from over 400 individuals and organizations. This material is contained in 4 volumes of over 3,600 printed pages.

Following the public hearings the committee considered the President's proposals in executive sessions over a period of several weeks. In those considerations the committee made certain *tentative* decisions for purposes of drafting a modified version of the President's proposals. The committee print, dated August 24, 1961, was the discussion draft prepared as a result of this committee action. Although no part of this draft has been approved by the committee, it was released for the information of the public. On August 23, 1961, the Committee on Ways and Means decided to defer action on the President's tax recommendations until next year. Chairman Wilbur D. Mills at that time in part said:

> The committee has worked diligently on the President's tax recommendations for 4 months, and now finds that it will be impossible to conclude its deliberation in the few weeks which remain in this session. This legislation will be perfected during the fall months, and will be the first order of business in the next session of this Congress.

This document is a general explanation of the released draft. This explanation has been prepared by the staff of the Joint Committee on Internal Revenue Taxation for the use of the Committee on Ways and Means and the general public. It has not been reviewed by the Committee on Ways and Means. An explanation of the Treasury draft on "tax haven" profits of controlled foreign corporations also is included in appendix A of this document.

II. SUMMARY

The discussion draft consists of 10 sections. The first indicates that the bill may be cited as the Revenue Act of 1961. The remaining nine sections would make substantive amendments to the Internal Revenue Code of 1954. They, together with the Treasury proposal on "tax havens," can be summarized as follows:

1. *Investment credit (sec. 2)*.—A credit against income tax is allowed for new investments (and for purchases of up to $50,000 of used property) made in 1961 and subsequent years. The credit generally is equal to 8 percent of the purchase price of domestic investments. It is not available for property with a useful life of less than 6 years and in general is limited to tangible personal property or other tangible property, apart from buildings, used in manufacturing, production, extraction, transportation, or communications. It also generally is not available in the case of public utilities.

2. *Entertainment, etc., expenses (sec. 3)*.—Restrictions are imposed on the deduction of entertainment expenses for income tax purposes. First, with specified exceptions, these expenses may not be deducted unless they relate directly to the production of income and are not merely for good will. Exceptions are provided for business meals, employee and stockholder meetings, trade association meetings, conventions, etc. Second, no deduction may be taken for business gifts to the extent they exceed $25 per recipient or for the payment of club dues. Third, entertainment and traveling expenses, to be deductible, must be substantiated in detail. Fourth, in the case of travel expenses, only a "reasonable allowance" may be deducted for meals and lodging.

3. *Mutual fire and casualty insurance companies, etc. (sec. 4)*.—Over a period of years mutual fire and casualty insurance companies are to be taxed on their underwriting income (their investment income presently is taxed) in substantially the same manner as stock casualty companies. After a 5-year transition period one-half of the underwriting income will be taxed in the year it is earned and the other half (to the extent it is not offset by intervening losses) will be taxed 5 years later. A transition rule gives partial exemption in the first 5 years. Small mutual companies will continue to be taxed only on investment income. Special provisions are applicable for reciprocal underwriters and interinsurers, factory mutual insurance companies, and companies with certain types of concentrated risks. In addition, the deduction now allowed life insurance companies for 2 percent of premium income from group accident and health business is repealed.

4. *Domestic corporations receiving dividends from foreign corporations (sec. 5)*.—Domestic corporations receiving dividends from foreign corporations, if they elect to claim a foreign tax credit for foreign income, etc., taxes paid on the dividends they receive, must also include in their income these same foreign taxes for which they claim credit. This has been referred to as "grossing up" these dividends by the amount of foreign taxes paid with respect to them. Other technical amendments are also made.

5. *Exclusion for income earned from sources outside the United States* (*sec. 6*).—Earned income derived from sources outside of the United States presently is not subject to U.S. income tax if the individual involved is a bona fide resident of the foreign country. The draft limits this exclusion to some specified amount (undetermined in the committee's tentative decisions). In addition, contributions by employers to pensions, where the individuals worked abroad, are to be fully taxable to the individuals if they reside in the United States at the time they receive the pension in the same manner as employees who worked in the United States.

6. *Gain from disposition of depreciable personal property* (*sec. 7*).—Any gain on the sale of most types of depreciable personal property, is to be treated as ordinary income to the extent of any depreciation deductions previously taken. For this purpose only depreciation deductions taken in 1961 and subsequent years will give rise to this ordinary income treatment. This ordinary income treatment is to be applicable only in the case of sales and certain other dispositions of depreciable personal property. Taxpayers will be permitted to change to more conservative forms of depreciation if they desire to do so in order to minimize the possibility of realizing ordinary income under this provision. Also, taxpayers under this provision will be permitted to ignore salvage value in determining their depreciation base to the extent of 10 percent of the cost or other basis for the property.

7. *Tax treatment of cooperatives and patrons* (*sec. 8*).—Cooperatives are to be permitted to deduct patronage dividends only when they are paid in money, "qualified scrip," or other property except nonqualified scrip. In addition, a deduction is provided for nonqualified scrip when it is redeemed. The same amounts are to be includible in the income of the patron at about the same time the cooperative takes the deduction (except where the patronage is attributable to personal expense items). "Qualified scrip" means scrip with respect to which the patron had an option to receive cash or scrip for a 90-day period after issuance, or, in the case of farm cooperatives, scrip issued only after the farmer within the year to which it relates consents in writing to received the dividend in scrip rather than cash. In the case of "exempt farm cooperatives," provision is also made for the deduction of amounts paid in money, qualified scrip, or other property (except nonqualified scrip) which is paid out of earnings derived from business done for the United States or from sources other than patronage, such as investment income.

8. *Withholding on interest, dividends, and patronage dividends* (*sec. 9*).—Provision is made for withholding at a rate of 16⅔ percent on interest, dividends, and patronage dividends. The recipient on reporting his income for tax purposes "grosses up" his net dividend or interest payment by one-fifth to obtain the gross payment which he reports for tax purposes. The withheld amount is then available as a credit against the tax otherwise due. No receipts are required under this system. A system of exemption certificates is provided for those having no tax liability and intraannual, or quick, refunds are provided for those where the withholding is excessive because of the number of their exemptions, eligibility for retirement income credit, etc.

9. *Information with respect to certain foreign entities (sec. 10).*—Under present law domestic corporations must furnish certain specified information with respect to foreign corporations which they control or foreign subsidiaries of these corporations. If the information is not supplied, reductions are made in any foreign tax credit the domestic corporation might otherwise enjoy. This reporting requirement is extended to include not only domestic corporations but also individuals controlling foreign corporations and also to require information to be supplied with respect to certain additional types of foreign subsidiaries. Another requirement of present law requires certain specified information to be supplied by American citizens or residents who are officers, directors, or important stockholders of foreign corporations if they held such positions or have such stock interests at any time within 60 days after the creation, organization, or reorganization of the foreign corporation. Beginning in 1962 such information is to be supplied by such American officers, directors, or important stockholders on January 1 of that year and also by those who become so at any time thereafter.

10. *Treasury proposal on "tax havens."*—The Treasury draft (available to the public but not in the committee print) identifies certain types of income—such as income from exports, imports, licensing, certain dividends and interest, and reinsurance. Where such income arises from transactions of a foreign corporation with a related party outside of the country in which the foreign corporation is organized, it is to be taxed currently to U.S. shareholders of the foreign corporation even though there is no dividend distribution. This treatment applies only where five or fewer U.S. shareholders own more than 50 percent of the stock of the foreign corporation and then only in the case of those shareholders owning 10 percent or more of the stock of the foreign corporation.

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III. INVESTMENT CREDIT

(Sec. 2 of the draft and secs. 38 and 46–48 of the code)

A. IN GENERAL

The President in his tax message requested the adoption of a tax incentive in the form of a credit against tax liability for certain types of investment. The 15-percent investment credit initially recommended by the President was designed to concentrate the stimulus provided by the credit among those who are increasing their rate of investment. Under this proposal most of the investment credit allowance would have been available only for plant and equipment expenditures in excess of current depreciation allowances. Also, a 6-percent credit would have been available for certain investment below the level of these allowances.

The discussion draft provides a flat rate 8 percent credit for investment without regard to the rate of investment of the taxpayer in the past. The draft omits from the types of investment for which a credit may be obtained buildings and limited types of other real property. Another significant modification in the credit in the draft is that it is made available for a limited amount of purchases of used assets as well as new.

B. MORE SPECIFICALLY

The draft provides a credit (in sec. 38) which may be offset against income tax liability. The credit is an amount equal to 8 percent of "qualified investment" which includes both purchases of new equipment and also, to a limited extent, purchases of used equipment. The types of property, whether new or used, which are included in qualified investment are described as "section 38 property." In general terms this property includes tangible personal property, such as equipment, and also certain real property, other than buildings, if the property is used directly in manufacturing, production, transportation, etc.

Once the amount of the 8-percent credit against tax is determined, the amount of the credit which can be claimed in any one year is limited to the tax liability, or if this tax liability exceeds $100,000, the credit which may be taken to the extent it exceeds $100,000 is limited to 50 percent of the tax liability over this amount. Credits in excess of this limitation can be carried forward for 5 years. Another feature provides, where the property with respect to which the investment credit was taken is disposed of within 6 years, that the credit may be disallowed if the Secretary of the Treasury determines that the allowance of the credit in such case is inconsistent with the purposes for which it was allowed.

The investment credit provisions are effective for taxable years ending after December 31, 1960. These provisions are described briefly below.

1. *Qualified investment.*—As indicated above, the investment which is eligible for the 8-percent investment credit is referred to as "qualified

investment" (sec. 46(c)). Property becomes qualified investment in the first year in which depreciation (or amortization) is allowable to the taxpayer with respect to the property. New property is treated as qualified investment if it is purchased or otherwise acquired after December 31, 1960, and if its original use began with the taxpayer after this date. It also includes property to the extent it is constructed, reconstructed or erected by the taxpayer after this date. These are the same rules which applied with respect to the new forms of depreciation provided in 1954.

Used property is treated as qualified investment only to the extent of $50,000 a year. This property also must be purchased after December 31, 1960, but of course need not be new in use with the taxpayer. To prevent abuse, however, there has been omitted from used property which may qualify that which is leased back to the person from whom it was acquired, and that which is leased to a corporation which controls, or is controlled by, the person from whom the property was acquired. In the case of husband and wife filing a joint return, $100,000 instead of $50,000 of used property may qualify. In the case of affiliated groups of corporations (with a 50 percent test of common ownership instead of the 80 percent usually applied), there is one $50,000 allowance with respect to used property, which is apportioned among the members of the group in accordance with their purchases of this property. In the case of partnerships, this limitation applies both at the partnership level and also with respect to each partner. Thus, there is a $50,000 limit with respect to the total amount of used property which may be qualified with respect to any partnership and then there is a further $50,000 limit at the partner level which applies where a partner, either from another partnership or as a sole proprietor, has made additional investment.

2. "*Section 38*" *property.*—Section 38 property (defined in sec. 48(a)) is the only property (whether new or used) which is treated as "qualified investment." Such property must be either tangible personal property, or other property, except buildings, which is used directly in manufacturing, production, extraction, transportation, or communications (including research and storage facilities with respect to any of these categories). Tangible personal property is not intended to be defined narrowly here or to necessarily follow the rules of State law. It is not intended to foreclose the classification as tangible personal property of property which is either affixed to a building or to land so long as the property is used in the operation of a trade or business.

Section 38 property must be depreciable property and is limited to that which has a useful life in the hands of the taxpayer of 6 years or more. This is not intended, however, to deny qualification merely on the grounds that similar property (because of rapid technological change, etc.) may have been used by the taxpayer in the past for less than 6 years if there is reason to believe that current assets will be used for a longer period of time.

There also are certain categories of property which are excluded from the definition of section 38 property and, therefore, cannot qualify for the credit. These exclusions are:

(1) Property used predominantly to furnish lodging or in connection with the furnishing of lodging.

(2) Property which is used in a public utility trade or business. Public utility for this purpose refers to the furnishing or sale of electrical energy, gas, water, or sewage disposal services or telephone or telegraph service. These types of businesses are excluded only if the rates for the furnishing or sale of the services are established or approved by a governmental unit.

(3) Property used by a tax-exempt organization other than in a business with respect to which the unrelated business income tax is imposed.

(4) Property used by governmental units.

(5) Property used predominantly outside of the United States. However, there are certain exceptions where this type of property is eligible for the credit, namely, in the case of domestically owned aircraft, rolling stock of railroads, vessels and motor vehicles where the use is partially within and partially without the United States. Similarly, an exception is made for domestically owned containers which are used in the transportation of property to or from the United States. A further exception is made for property used by a domestic corporation, citizen or resident in exploring for, developing, removing, or transporting natural resources (e.g., oil) from the Outer Continental Shelf.

Lodging, or residential real estate, and furnishings and equipment used in connection therewith, are excluded on the grounds that this property for the most part is used by consumers rather than in production. Public utilities were omitted from the base for the investment credit on the grounds that they are subject to regulations generally designed to limit the rate of return on investment after payment of tax and on the grounds that their growth is largely determined by public requirements.

The limitation on the allowance of credit in the case of tax-exempt organizations is designed to prevent an investment for use in connection with an exempt function from decreasing the tax on any unrelated trade or business. Property leased to governmental units is omitted since allowing the lessor in such cases an investment credit would not be expected to increase leasing by the governmental units. Property used predominantly outside of the United States (with the exceptions noted) is omitted since income from sources outside of the United States generally is subject to tax only to the extent that the United States rates exceed the applicable foreign rates.

3. *Limitation on tax credit.*—The tax credit under the discussion draft cannot exceed the tax liability, or if the tax liability is in excess of $100,000, may not exceed $100,000 plus 50 percent of the tax liability in excess of this amount. This limitation, while leaving substantial leeway for utilizing the credit, is designed to prevent it in combination with other tax credits, deductions, etc., from wiping out tax liability and thereby relieving the taxpayer from a substantial tax contribution. However, in recognition of the problems of small business, the draft does not impose this limitation with respect to any tax liability up to $100,000.

Although this limitation with respect to the allowance of the investment credit is imposed with respect to the year in which the investment is made, nevertheless, any investment credit which because of this limitation cannot be used in the current year can be carried forward by the taxpayer and used in any of the 5 succeeding years.

Tax liability for purposes of this limitation is computed without regard to the accumulated earnings tax or personal holding company tax liability but after the application of the foreign tax credit, the 4 percent dividends received credit and the credits for partially tax-exempt interest and retirement income. Generally in the case of married individuals filing separate returns, the limitation with respect to each spouse is $50,000 instead of $100,000 of tax liability. However, if one of the two has no qualified investment or unused credit carryover, the one having the investment, or carryover, may make use of the entire $100,000.

4. *Recapture provision.*—To guard against a quick turnover of assets in order to obtain multiple credits the draft provides (sec. 47) that, if the property is disposed of or otherwise ceases to be section 38 property (such as through use predominantly outside of the United States) or is leased within 6 years of the time the property was first placed in service, the property is to be excluded from qualified investment back in the year in which the credit was taken. The statute of limitations is kept open with respect to this recapture rule until 3 years after the date of filing the tax return for the year in which the sale or other disqualifying event took place.

The recapture provision applies only if the Secretary of the Treasury or his delegate determines, on the basis of all the facts and circumstances, that the allowance of the credit with respect to the property would confer a benefit which is inconsistent with the purposes of the investment tax credit provision. Certain standards are provided in the statute to aid in determining whether a benefit is inconsistent with the purposes of the provision. They are:

(1) The relationship of the taxpayer to the transferee or lessee (where there is a close relationship the transfer or lease might have taken place in order to obtain a double credit).

(2) Subsequent use of the property (for example, is it shipped for use outside the United States?).

(3) The frequency of disposition of the assets (thus, for example, does the taxpayer make a practice of disposing of these assets in less than 6 years, then obtain other similar assets, and in that manner obtain multiple credits?).

(4) Whether the transfer or lease serves a bona fide business purpose.

These, of course, are not the only factors the Secretary or his delegate is to take into consideration in making this determination.

5. *Election for leased property.*—The discussion draft provides (in sec. 48(d)) that a person engaged in the business of leasing property may elect with respect to new section 38 property to treat the investment as if made by the lessee instead of the lessor. This election applies only with respect to new section 38 property and is not available with respect to used property. Also, the election is available only with respect to the first lessee of new property.

If the lessor makes this election, then the lessee is treated for purposes of this provision as if he had acquired the property himself. Generally, the lessee will be treated as having acquired the property for the cost or other basis of the lessor in the property. However, if the lessor (or a corporation controlling or controlled by the lessor) constructed the property, the lessee is treated as having acquired the property for its fair market value. The investment credit may be

passed on in the case of these leases on the grounds that it is the decision of the lessee which in most cases brings about the demand for the additional investment.

6. *Special classes of taxpayers.*—A number of special categories of taxpayers receive special tax treatment under the Internal Revenue Code. For still other taxpayers, income may be taxed in part to the organization and in part to its shareholders or beneficiaries. In these situations, the draft either cuts down the allowance of the tax credit in proportion to the special benefit received, or provides for the apportioning of the investment credit between the organization and its shareholders or beneficiaries in accordance with their sharing of the income for tax purposes.

As a result, the draft (sec. 46(d)) provides that the qualified investment and the $100,000 tax liability limitation are to be ratably reduced in the case of mutual savings banks, domestic building and loan associations or cooperative banks, regulated investment companies, real estate investment trusts, and cooperative organizations. In the case of the mutual savings banks, etc., the ratable share of the qualified investment and $100,000 limitation is determined by multiplying them by a fraction in which the numerator is the organization's taxable income and the denominator is its taxable income plus any deduction allowed for the addition to a reserve for bad debts described in section 593 of the code. In the case of regulated investment companies or real estate investment trusts, their ratable share of the qualified investment and $100,000 limitation is determined by multiplying them by a fraction in which the numerator is their investment company taxable income, or real estate investment trust taxable income, and in which the denominator is this same taxable income computed without regard for the dividends paid to shareholders or beneficiaries. In the case of cooperative organizations, the proportion of qualified investment and $100,000 limitation to be taken into account is determined by multiplying them by a fraction whose numerator is the cooperative's taxable income and whose denominator is the cooperative's taxable income without deduction for patronage dividends (or in the case of exempt cooperatives, also without regard to its deduction for dividend payments on capital stock, patronage distributions with respect to business done with the United States or income distributed to patrons from sources other than patronage).

In the case of subchapter S corporations; i.e., corporations treated in a manner similar to that of partnerships, the draft provides (sec. 48(e)) that the qualified investment for each taxable year is to be apportioned pro rata among the persons who are shareholders of the corporation at the end of the year. In these cases, the shareholder is to be treated as the taxpayer with respect to the investment and the investment is to maintain its character as new or used section 38 property as the case may be. Similarly, the draft provides (sec. 48(f)) that qualified investment in the case of estates or trusts is to be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each. As in a manner similar to that applied to subchapter S corporations, the beneficiary is to be treated as the taxpayer with respect to the investment apportioned to him, and the investment is to retain its character as new or used section 38 property in his hands. The $100,000 limitation in the case of the estate or trust is to be reduced

to an amount which bears the same ratio to $100,000 as the qualified investment allocated to the estate or trust bears to the entire amount of qualified investment.

7. *Carryovers in certain corporate acquisitions.*—In the case of certain tax-free acquisitions of assets of one corporation by another, certain items of the first corporation under present law are carried over and attributed to the second corporation. The draft adds to this list (sec. 381(c)(23)) provision for a carryover to the acquiring corporation of the status of the prior corporation with respect to the items required to be taken into account for purposes of the investment credit. This is mainly concerned with the carryover of the possibility of recapture and the carryover of any unused investment credit in the prior 5 years arising from the application of the $100,000—50 percent limitation.

IV. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

(Sec. 3 of the draft and secs. 274 and 162(a)(2) of code)

A. IN GENERAL

The President proposed the virtual elimination of the deduction for entertainment expenses. The discussion draft imposes restrictions on the deductibility of entertainment expenses but retains the basic concept of the deductibility of these expenses. First, it provides, with certain exceptions, that entertainment expenses to be deductible must be directly related to the production of income and not merely for goodwill. Exceptions to this provision are provided for such items as business meals which are held under circumstances conducive to business discussions, employee and stockholder meetings, and trade association meetings and conventions. In the case of these areas excepted from this first change, present rules will continue to apply. In the case of other entertainment expenses, however, not only will present limitations apply but in addition the further restrictive conditions set out in the first change also must be met.

Requiring entertainment expenses generally, in order to be deductible, to be directly related to production of income and not merely for goodwill means that there must be a specific business purpose (whether or not the expenses actually result in the fruition of income). Also, since they must be not merely for the purpose of creating or maintaining goodwill, this means that it is not enough to merely have the expectation that the expenses may result in business sometime in the future.

Second, the discussion draft denies any deduction for club dues and fees, and limits the deductibility of business gifts to $25 per recipient per year.

Third, the draft provides that entertainment expense deductions in order to be deductible, must be substantiated in detail. This latter requirement also applies to traveling expenses.

The present provision relating to the deductibility of traveling expenses also is amended by providing that instead of deducting the "entire amount spent for meals and lodging" while in the travel status, only a "reasonable allowance for amounts spent for meals and lodging" will be deductible.

These amendments relating to entertainment and traveling expenses are to apply to taxable years ending after December 31, 1961, but only with respect to periods after that date. The entertainment and travel expense restrictions which have been referred to above are described briefly below.

B. MORE SPECIFICALLY

The draft adds a new section to the code (sec. 274) disallowing certain travel and entertainment expense deductions. This disallow-

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ance provision in no way relieves requirements of existing law such as the requirement that expenses be ordinary and necessary; this provision will not result in the allowance of deductions for any expenses which are disallowed under present law.

1. *Requirement that expenses be directly related to income.*—With eight specified exceptions, the draft provides (sec. 274(a)) that no deduction is to be allowed for entertainment, amusement, or recreation expenses or for related facilities except to the extent the taxpayer establishes that the item was "directly related to the production of income and was not merely for goodwill."

The term "entertainment, amusement, and recreation," as used in the draft, is intended to include expenses (and facilities) for food and beverages and also personal, living, or family expenses for employees or business associates to the extent such expenses (or facilities) are claimed as business expense deductions.

The effect of this provision will be to deny expenses for entertaining guests at night clubs, theaters, country clubs, prize fights, hunting and fishing trips, etc., unless the taxpayer can show that the incurring of such expenses was directly related to specific attempts to obtain or continue business (whether or not the attempts were successful). The expenses will not be deductible if they are made merely in the hope of creating friendships or obligations which may or may not lead to business in the future. Thus, the incurring of entertainment expenses such as those referred to above, where there are large groups or where there are distractions which are not likely to be conducive to specific business discussions, will be suspect unless the taxpayer can show that they are related to specific business activity and not merely to goodwill. This will also be true of deductions for such facilities as yachts, hunting lodges, and fishing camps.

The goodwill factor referred to above may be a significant factor without resulting in the loss of deductions so long as the expenses are not "merely" for that purpose and there are other significant reasons, directly related to obtaining business, for incurring the entertainment, etc., expenses.

2. *Exceptions where requirement as to direct relationship to income will not exist.*—Where an expense falls within specified categories it is not necessary, for it to be deductible, that it meet the requirement of being directly related to the production of income and not merely for goodwill (sec. 274(d)). However, in these excepted areas all of the restrictions of existing law will continue to apply (and also the "substantiation" requirements set forth under heading No. 4 below). Of course the fact that an expense does not meet the terms of any of the exceptions noted below does not mean that it will be denied as an entertainment, etc., expense, if it can be shown that it is directly related to the production of income and not merely to the creation of goodwill. The exceptions are as follows:

(a) A reasonable allowance for food and beverages furnished under circumstances which are of a type generally considered to be conducive to a business discussion is the first exception. The question as to whether the circumstances are conducive to a business discussion are to be tested on such standards as: First, the surroundings in which the meal was furnished; second, the taxpayer's trade or business or income-producing activity; and

third, the relationship to such trade, business, or activity of the persons to whom the food and beverages are furnished.

(b) An exception is made for expenses for food and beverages (and facilities used in connection with them) furnished on the business premises of the taxpayer primarily for his employees. This is intended to exclude facilities such as the company cafeteria or an executive's dining room. This exception would continue to apply even though guests are occasionally served in the cafeteria or dining room.

(c) An exception is made for expenses for goods, services, and facilities which are treated by the taxpayer as compensation paid to an employee and from which income tax is withheld.

(d) An exception is made for expenses paid or incurred by the taxpayer where he pays or incurs the expenses for his employer or a client, customer, etc., and where he is reimbursed by the employer or client, etc. This is designed to prevent the double disallowance of a single expenditure, once to the employee or practitioner, etc., and a second time to the employer or client, etc. This provision will not apply, however, in the case of an employee where the employer treats the amount paid to him as compensation. It also will not apply in the case of a client, etc., unless the practitioner, etc., accounts to him for the expenses incurred. The accounting must represent sufficient substantiation to meet the tests set out under topic No. 4 listed below.

(e) An exception is provided for expenses incurred for recreational, social, or similar activities (including facilities) primarily for the benefit of employees. The employees referred to in this case are those other than officers, shareholders, or highly compensated employees. In this case an individual would be considered a shareholder only if he (taking into account holdings of members of his family) holds an interest in the corporation of 10 percent or more. This category is intended to exclude the usual employee fringe benefit programs, such as expenses of operating a company swimming pool or baseball diamond, as well as the expenses of the annual company picnic or Christmas office party.

(f) Expenses directly related to business meetings of employees or stockholders are also excepted. While this category will exclude business meetings where some social activities are provided, it is not intended to exclude gatherings which are primarily for social purposes rather than for the transaction of the employer's or company's business.

(g) A further exception is provided for expenses directly related and necessary to attendance at a business meeting of any organization, such as a trade association, chamber of commerce, real estate board, etc., described in section 501(c)(6) of the code and exempt from income tax.

(h) An exception is also provided for goods, services, and facilities made available to the general public either free of charge or for a nominal charge. This excludes expenses for entertainment of the general public by means of television, radio, newspapers and the like. It also does not bar deductions for expenses for parks, etc., maintained by companies where the general public may attend either without charge or for a nominal charge. Expenses of distributing samples to the general public would be another example of this exception.

3. *Expenditures disallowed in all cases.*—Two categories of deductions are disallowed (sec. 274(b)) in all cases: club dues and fees paid to any social, athletic, or sporting club or organization (except dues or fees paid by a professional athlete essential to the conduct of his trade or business) and business gifts to the extent that they, in total value during the year, exceed $25 with respect to any person. The reference to social, athletic, or sporting club is intended to deny a deduction with respect to amounts which are subject to the excise tax on club dues. In addition, it will apply to amounts paid to clubs to which the club dues tax would apply but for a specific exemption, such as fraternal societies, swimming clubs, etc.

There is the possibility of overlapping application of two provisions in the new section added to the code: what might be held to constitute a gift might also be held to constitute entertainment expenses. Since different rules apply in these cases, specific regulatory authority is given to the Secretary of the Treasury or his delegate to prescribe, in cases where both provisions would otherwise apply, which provision is to govern. Thus, for example, a "gift" of theater tickets, although technically also under the gift section, probably would be classified by the Secretary or his delegate as coming under the entertainment provision, while a book probably would be classified as coming under the gift provision.

4. *Disallowance of expenditures not substantiated.*—The draft provides that for either entertainment, amusement or recreational expenses, or traveling expenses to be deductible, the taxpayer must substantiate by adequate records or other sufficient evidence the amount of the expense or other item, the time and place of the travel, entertainment, amusement, or recreation (or use of the facility), the business purpose of the expense or other item and the business relationship to the taxpayer of the person entertained or using the facility. This provision is intended to overrule the case of *Cohan* v. *Commissioner* (39 F. 2d 540; C.A. 2d 1930) which held that, where the evidence indicated that a taxpayer had incurred a deductible expense, but its exact amount could not be determined, the court must make "as close an approximation as it can" rather than disallow the deduction entirely. Under the draft, the expenses in such a case would be disallowed entirely.

5. *Meals and lodging while in travel status.*—The draft also amends the provision of existing law (sec. 162(a)(2)) which in referring to traveling expenses indicates that they include "the entire amount expended for meals and lodging." The discussion draft provides instead that these traveling expenses include "a reasonable allowance for amounts expended for meals and lodging."

V. MUTUAL FIRE AND CASUALTY INSURANCE COMPANIES, ETC.

(Sec. 4 of the draft and secs. 821 to 824, 831, 832, and 809(d)(6) of the code)

A. IN GENERAL

Stock fire and casualty insurance companies have long been taxed at ordinary corporate income tax rates on both investment income and underwriting income. Mutual fire and casualty insurance companies on the other hand since 1941 have paid tax under special formulas which do not take into account their underwriting income. Generally, these mutual companies are taxed under whichever of two formulas results in the higher tax. Under one formula, they are taxed on investment income only at ordinary corporate income tax rates. Under the other, they pay a tax of 1 percent on their gross investment income plus their premium income after policyholder dividends. Reciprocal underwriters and interinsurers are taxed only on their investment income. Mutual companies with total receipts of not more than $75,000 are tax exempt.

The President recommended that stock and mutual fire and casualty insurance companies be taxed the same. In other words, he proposed that mutual companies pay tax on their underwriting profits substantially in the same manner as stock companies. The discussion draft, requires that over a period of years, underwriting income (or loss) of mutual companies be taken into account for income tax purposes and therefore eventually would achieve the result sought by the President.

After a 5-year transition period, one-half of underwriting income will be taxed in the year it is realized and the other one-half included in income (and taxed) in the fifth succeeding year unless it has been offset by intervening losses. During the transition period partial exemption, rather than tax deferral, is provided in order to ease the shift over to the new tax treatment. The tax deferral is provided to aid mutual companies in finding sufficient funds to provide for the possibility of underwriting losses. This deferral provides a fund equal to average underwriting income for a 2½-year period out of which major losses may be paid. However, this does not prevent the operation of the normal 3-year carryback and 5-year carryforward of any net losses which may remain after using up funds in this deferral account.

The treatment described above applies only to mutual companies with total receipts—gross investment income plus premiums received—above $300,000. Those with lesser total receipts will pay Federal income tax only on investment income or, if they have total receipts of no more than $75,000, will continue to be exempt from tax as under existing law. Thus, the small companies will not be affected adversely by this change in the law and may be benefited by the elimination of the alternative tax on total receipts. Special treatment

also is provided for mutual casualty companies whose risks of loss by windstorm, hail, flood, earthquake, or similar hazard are concentrated in one State. The special tax treatment enables them to build relatively larger reserves for catastrophe losses.

Reciprocal underwriters and interinsurers, although generally treated like the other mutuals, are allowed a special deduction. The deduction is for amounts credited to individual subscribers' accounts where the subscriber would be permitted to draw the amounts down if his policy were terminated at that time. This treatment takes into account the special characteristics of "pure" or "classical" reciprocal companies.

In the case of factory mutual insurance companies, the draft provides that in the future these companies will be treated for tax purposes as if they were stock companies. However, the premium income of these factory mutuals will be computed on the basis of "absorbed premiums" increased by 2 percent. "Absorbed premiums" rather than "earned premiums" in the conventional sense are used, since this is the proportion of the premiums actually taken into account by the factory mutuals. Nevertheless, since unabsorbed deposits are available to the companies, a 2-percent addition to income is provided.

In addition to the modifications described above applicable to mutual fire and casualty insurance companies, the draft also provides a modification in the tax treatment of life insurance companies. The special deduction of 2 percent of premiums attributable to group accident and health insurance policies is repealed. Presently, this deduction is available to life insurance companies but not to casualty companies writing the same line of business.

These changes are effective for taxable years beginning after December 31, 1961.

B. MORE SPECIFICALLY

1. *Taxation of underwriting income.*—Under the discussion draft, mutual fire and casualty insurance companies, after a 5-year transition period, will be taxed at ordinary corporate rates on underwriting income, as well as on investment income, and will be allowed deductions for underwriting losses. Underwriting income (or loss) is defined as the difference between total net earnings from all sources and taxable investment income. In general, these companies will be taxed in the current year on their net investment income plus 50 percent of their underwriting income. The other 50 percent of their underwriting income will be credited to a special account as a cushion against subsequent underwriting losses. To the extent there are no such losses, amounts credited to this special deferred gain account will be included in underwriting income in the fifth year following the year in which they were credited, and will be taxed at that time.

Losses, if any, will first reduce amounts credited to the deferred gain account, and then will be applied against taxable investment income for the year. Any losses remaining may be carried back for 3 years and then over for five years. The deduction of these underwriting losses will be of special benefit to mutual companies with such losses, since under present law mutual companies are not permitted to reduce investment income (or the aggregate receipts on which the present alternative 1-percent tax is based) by underwriting losses.

In computing their taxable income, mutual companies will be allowed an unlimited deduction for dividends paid to policyholders.

No such deduction is available under present law, because underwriting income heretofore has not been taxed.

Under present law mutual insurance companies which are not subject to the 1-percent alternative tax are allowed a special exemption of $3,000, with the tax on taxable incomes between $3,000 and $6,000 gradually increasing until the exemption completely vanishes when taxable income reaches $6,000. The draft increases this special exemption (applicable to the new total of investment and underwriting income) to $6,000 in the case of mutual companies taxable under the general rules of the draft. There also is a gradually increasing tax on taxable incomes between $6,000 and $12,000, so the exemption vanishes when taxable income reaches $12,000.

The discussion draft extends the generally applicable 3-year carryback and 5-year carryforward of net operating losses to mutual insurance companies, effective for 1962 and subsequent years. Losses in the pre-1962 years cannot be carried forward into the period to which the new treatment applies and losses after 1961 cannot be carried back against income in years to which the old rules apply.

2. *Transition rules.*—To lessen the impact on the mutual fire and casualty insurance industry of taxing underwriting income for the first time, the draft provides for a "phase-in" over a 5-year period of the full effect of bringing underwriting income into the tax base.

In the first year of operation (1962), only one-half of the underwriting income will be taxed. The remaining one-half of underwriting income will continue to be exempt as under present law. In each succeeding year, an increasing percentage of underwriting profits will be brought into taxable income (but the tax on it deferred for 5 years), so that after 5 years the entire underwriting gain will be taken into account. The percentages of underwriting income which will be taxable immediately, tax exempt, and deferred during the transition period are shown by the following schedule:

In the case of a taxable year beginning in—	The percentage taxed immediately is—	The percentage deferred is—	The percentage tax exempt is—
1962	50	0	50
1963	50	10	40
1964	50	20	30
1965	50	30	20
1966	50	40	10
1967	50	50	0

If the insurance company encounters underwriting losses in the transition period, the percentage of the loss which may be deducted is to be the same as the percentage of underwriting income which would have to be taken into account (both immediately and on a deferred basis) for that year under the foregoing schedule. Thus, if an underwriting loss occurs in 1962 (the first year under the draft), only 50 percent of that loss may be deducted since in that year only 50 percent of the underwriting gain would have been taxed. Similarly, if a loss occurs in 1966, 90 percent of the loss would be deductible.

3. *Small companies.*—Under the discussion draft small mutual insurance companies (those whose total receipts—gross investment income (excluding capital gains) plus premiums—exceed $75,000 but do not exceed $300,000) are not taxed on underwriting income. As

under present law, these companies will continue to pay tax on investment income only, but the alternative 1-percent tax will no longer apply. The special exemption of $3,000, with notch rates applying to taxable incomes between $3,000 and $6,000, also will continue in effect. Because many of these small companies are of the assessment type, they are not required to submit annual statements to the National Convention of Insurance Commissioners. In addition, many of them do not maintain adequate records for the computation of underwriting income. Therefore the draft continues to treat these small companies the same as under present law, except that the alternative 1-percent tax will not apply. Thus, as under present law, their losses from underwriting will not be deductible.

Despite the general rule described above, the draft permits these small companies to elect to be taxed on total income, including underwriting income, in the same manner as other mutual companies, and such an electing company will be allowed to deduct underwriting losses. Presumably the existence or expectation of losses will be the primary reason for making this election. The election, once made, cannot be changed without the consent of the Treasury Department. On the other hand, a small mutual company which becomes taxable under the general rules because its gross investment income plus premiums exceed $300,000 in a taxable year, again will be taxed as a small company if its income falls below this level if one condition is met. If while it was taxed under the regular formula it was required to credit a portion of its underwriting income to the deferred gain account, this amount must be taken into income and a tax paid on it before the small company treatment will again apply. In order to provide consistency of tax treatment for these small companies, the draft does not permit loss carrybacks or carryovers to be carried from a year in which the company was taxable as a regular mutual to, or through, a year in which it was taxable as a small company.

4. *Casualty companies with concentrated windstorm, etc., risks.*—As stated above, mutual insurance companies ordinarily will report and pay a tax on one-half of their underwriting income in the year it is earned. The remaining one-half will be credited to a deferred gain account and will not be taken into taxable income for a 5-year period. With respect to certain insurance companies whose risks from losses from windstorm, hail, flood, earthquakes, or similar hazards are concentrated in one State, the discussion draft permits deferral of an amount greater than 50 percent, with the result that a smaller portion of the underwriting income of these concentrated risk companies is included in the taxable income in the year it is earned. The percentage of underwriting income which can be deferred is determined by dividing the amount of premiums earned on insurance contracts, attributable to one State, relating to losses from windstorm, hail, flood, earthquakes, or similar hazards by the total amount of premiums earned by the insurance company. If this does not exceed 50 percent the regular deferral rule is used. If it does, the higher percentage may be deferred.

5. *Special deduction for reciprocal underwriters and interinsurers.*—Under present law reciprocal underwriters and interinsurers are not taxed in the same way as ordinary mutual companies, since they are not subject to the alternative 1 percent tax and they have a special

exemption. Under the discussion draft these companies are, in general, taxed in the same way as ordinary mutuals.

Although these companies in general are treated like other mutual companies, the draft includes a provision which permits reciprocal underwriters or interinsurers to deduct savings credited to individual subscribers' accounts (in the same manner as policyholder dividends paid in cash) if the company would be obligated to pay those amounts promptly to the subscriber if he terminated his contract. This is provided because the pure, or classical, reciprocal or interinsurer typically credits the account of each policyholder with savings attributable to his contract and because the policyholder has a right to receive the amount so credited if he leaves the exchange. Because amounts credited to the account of an individual subscriber represent reductions to him in the cost of insurance, the draft provides that for income tax purposes the subscriber must reflect this reduction when the credit is made. The draft in effect requires the business policyholder of a reciprocal exchange to reduce his deduction for insurance costs by the amount credited to his account in the exchange.

6. *Factory mutual insurance companies.*—Under present law, factory mutual insurance companies are taxed under the same formulas as other mutuals, that is, they pay tax on investment income only (with no deduction for underwriting losses) or under the alternative 1 percent formula. However, because of the very large premium deposits required of their policyholders, investment income of such companies typically is very large so that they in fact never become subject to the alternative 1 percent tax.

The discussion draft amends the law with respect to factory mutual companies in two important respects. First, commencing in 1962, these companies will be treated for tax purposes as if they were stock companies. This means that they will not qualify for the deferral of underwriting income which the draft permits in the case of other mutuals, but must pay tax on such income in the year earned. Underwriting losses of these companies after 1961 will be deductible in full. Secondly, the method of computing premium income of factory mutuals is modified to conform more closely to the actual operation of these companies. Without such a modification, the very large premium deposits, which would otherwise be taken into account ratably as premiums under the accounting rules laid down by insurance commissioners (with returns to policyholders treated as dividends), would overstate underwriting income for growing companies. Under this modification, premiums earned by factory mutuals will be equal to the amount of the premium deposit actually absorbed by the factory mutual, increased by 2 percent of the absorbed premium. This adjustment is intended to place the underwriting accounts of factory mutual companies in a position of substantial equality with other types of insurance companies with which they compete. This adjustment is designed to take account of the fact that the absorbed premium method of measuring earned premiums in effect allows an advance deduction for policyholder dividends.

7. *Group accident and health policies.*—Under present law, life insurance companies writing group accident and health and group life insurance policies are given a deduction of 2 percent of the net premiums from these sources, subject to certain limitations. Casualty

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insurance companies writing group accident and health policies are not allowed such a deduction. The draft removes this difference in treatment by providing that the deduction now allowed life insurance companies with respect to group accident and health policies is to be terminated, effective for taxable years beginning after December 31, 1961. Life insurance companies, however, may continue to deduct 2 percent of premiums from group life insurance contracts.

VI. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

(Sec. 5 of the draft and secs. 902 and 78 of code)

A. IN GENERAL

The President in his tax message to Congress stated that the method by which the credit for foreign income tax is computed in the case of dividends from a foreign corporation involves a double allowance for foreign income taxes and should be corrected.

The problem with which he is concerned arises from the fact that when the foreign tax rates is below the U.S. tax rate, the amount paid in foreign taxes is allowed once in effect as a deduction (since the dividends can only be paid out of income remaining after payment of the foreign tax), and a second time as a credit in computing the U.S. tax of the corporation receiving the dividend.

This can be illustrated by assuming that a foreign government imposes a 30-percent tax with respect to $1,000 of income of a corporation. This would leave $700 of the $1,000 out of which a dividend could be paid to a U.S. parent corporation. If this full amount is paid as a dividend and the applicable U.S. tax rate is 52 percent, the American tax on this $700 before the allowance of any foreign tax credit would be $364. On the other hand, if the $1,000 of income had been earned by a branch of the U.S. corporation, the entire $1,000 would be subject to U.S. tax before allowance of any foreign tax credit. Thus, in this case the tentative U.S. tax would be $520, or $156 more than in the case where the U.S. corporation has the foreign subsidiary.

In the case where the U.S. corporation has the foreign subsidiary, the foreign tax allowed as a credit is limited to the same proportion of the tax which the income included in the American tax base is of the total income.[1] Thus, the allowable credit for the foreign tax paid by the foreign subsidiary is limited to seven-tenths of the $300 or is limited to $210. As a result, the final U.S. tax for the dividend from the foreign subsidiary is $154 ($364 minus $210). This U.S. tax of $154, plus the foreign tax of $300, results in a total tax of $454, which is $66 less than the full $520 tax which would be paid by a domestic corporation operating in this country, or operating abroad through a branch.[2]

The size of this tax differential which exists in the case of dividends from foreign subsidiaries at the present time varies with the size of the foreign tax rate. As shown in table 1, the tax differential disappears either when the foreign tax rate equals or exceeds the U.S. tax or when no foreign tax is imposed. The maximum tax differential, given a 52-percent U.S. tax rate, occurs when the foreign tax rate

[1] This is the result of the decision in *American Chicle Company* v. *U.S.* (316 U.S. 450, 1942).

[2] As indicated above, the U.S. tax before credit in the case of the branch would be $520. After allowing the $300 foreign tax credit in this case, the final U.S. tax would be $220 which, with the $300 of foreign tax, means a total tax of $520.

is half that, or 26 percent. The differential at this point is 6.7 percentage points.[3] Where dividends are received by a domestic corporation from its subsidiary, which in turn has received its income from a subsidiary, the maximum tax differential (given the 52-percent U.S. tax rate) amounts to 11.93 percentage points.

TABLE 1.—*Rate differential for dividends from foreign subsidiaries with various selected foreign income tax rates and present 52 percent U.S. rate*

Income before tax	Foreign tax	Income available for dividend	U.S. tax before credit	Credit against U.S. tax	U.S. tax	Total tax	Rate differential of foreign subsidiary
							Percentage points
$100	0	$100	$52.00	0	$52.00	$52.00	0
$100	$5	95	49.40	$4.75	44.65	49.65	2.35
$100	10	90	46.80	9.00	37.80	47.80	4.20
$100	20	80	41.60	16.00	25.60	45.60	6.40
$100	26	74	38.48	19.24	19.24	45.24	6.76
$100	30	70	36.40	21.00	15.40	45.40	6.60
$100	40	60	31.20	24.00	7.20	47.20	4.80
$100	50	50	26.00	25.00	1.00	51.00	1.00
$100	52	48	24.96	24.96	0	52.00	0

The discussion draft deals with this problem by providing that where a U.S. corporation elects the foreign tax credit, it must increase, or "gross-up," its U.S. tax base by including the amount of foreign income paid in taxes which is attributable to the dividend received. Thus, in the example cited above, the tentative U.S. tax would be computed on the basis of $1,000, instead of $700, and then the full $300 of foreign taxes would be allowed as a tax credit, in the same way as the tax on branches of U.S. corporations is determined at the present time.

Two relatively minor technical amendments recommended by the administration are also included with this provision. One of these involves the repeal of a subsection (sec. 902(d)) of one of the foreign tax credit provisions, which makes the foreign tax credit available in limited cases with respect to royalty income received from a foreign subsidiary, where the domestic corporation owns all of the stock of the subsidiary. The provision granting this treatment in the case of royalty income was adopted in 1954 in order to grant relief in a case where under currency exchange restrictions, a corporation was prohibited from distributing its earnings but was able to transfer property to the parent as royalties. This provision has the effect of accelerating the time of the allowance of the credit to the parent. Instead of allowing the credit in the year the profits taxed by the foreign country are distributed, the credit may be allowed in an earlier year when the parent receives from its subsidiary a royalty payment representing income not taxed to the foreign subsidiary. The discussion draft repeals this subsection.

Second, the draft also follows a recommendation of the administration relating to the interrelationship of the foreign tax credit and the intercorporate dividends-received deduction. Where a foreign corporation derives 50 percent or more of its income from sources

[3] The tax differential represents the difference between the U.S. and foreign tax rates, multiplied by the income omitted from the U.S. tax base.

within the United States, a domestic corporation receiving dividends from it is eligible for the 85-percent intercorporate dividends-received deduction. This deduction is available with respect to the portion of the income determined to be from sources within the United States. However, all of the remaining income is treated as income from sources without the United States for which a foreign tax credit is available, including the 15-percent amount remaining after the allowance of the intercorporate dividends-received deduction which, for that purpose, was treated as income from sources within the United States. The administration recommended that this 15 percent of domestic source income, remaining after the dividend-received deduction is allowed, retain its domestic source character rather than being reclassified as foreign source income for purposes of the foreign tax credit. The draft carries out this policy.

The provisions referred to above are to apply with respect to dividends received by domestic corporations in taxable years beginning after December 31, 1961.

B. MORE SPECIFICALLY

1. *Inclusion of foreign taxes in income.*—The provision adds a new section to the code (sec. 78) which provides that if a domestic corporation elects to take the foreign tax credit it must take into its gross income an amount equal to the taxes of the subsidiary (or an amount equal to the taxes of its subsidiary's subsidiary) it is considered, or deemed, to have paid for purposes of the foreign tax credit provision. Thus, for a domestic corporation to claim a foreign tax credit for foreign taxes paid by its subsidiary or a subsidiary of that subsidiary, it must "gross up" its dividend income received by the amount of the foreign income, etc., taxes attributable to it.

Other provisions of the code (sec. 902 (c), (a), and (b)) are also amended to carry out fully the "gross-up" referred to in the prior paragraph. Thus, the definition of the term accumulated profits for purposes of the foreign tax credit is modified to include the income taxes imposed by a foreign country (or U.S. possession) which are taken into account by the domestic corporation.

2. *Dividends from U.S. sources.*—The draft amends the rules used in determining whether income is from within or without the United States in the case of a foreign corporation which has engaged in business in the United States and has received 50 percent or more of its gross income for the 3 prior years from sources within the United States. In such a case, the 85-percent intercorporate dividends-received deduction is available with respect to the proportion of its income which its income for the 3-year period derived from sources within the United States bears to its income from all sources. However, under present law all of such a corporation's income, to the extent it exceeds the 85-percent deduction allowed for intercorporate dividends received, is treated (for the purpose of the foreign tax credit) as income from sources without the United States. Thus, the 15 percent for which no intercorporate dividends received deduction is allowed, although for purposes of the prior computation treated as from sources within the United States, is for this purpose treated as foreign source income. The draft changes this by providing that the

amount treated as foreign source income in such a case is only the remaining income in excess of this 15 percent.

3. *Royalty income eligible for foreign tax credit.*—The draft repeals the provision of present law (sec. 902(d)) which treats as a distribution (and, therefore, eligible for the foreign tax credit) royalty payments received by a domestic corporation from a 100-percent owned subsidiary engaged in manufacturing, production, or mining.

VII. EARNED INCOME FROM SOURCES OUTSIDE THE UNITED STATES

(Sec. 6 of the draft and secs. 911 and 72(f) of the code)

A. IN GENERAL

Under present law an individual citizen of the United States who is a bona fide resident of a foreign country may exclude from his U.S. tax base his entire earned income from sources outside of the United States. In addition, an individual who goes abroad, but does not establish a foreign residence, may exclude from his U.S. tax base his earned income up to $20,000 a year if he remains abroad for a period of 17 out of 18 consecutive months.

The President recommended that in the case of citizens living abroad in developed countries there be no exclusion for income earned abroad. In the case of underdeveloped countries he would keep the present exclusion of up to $20,000 a year in the case of those who are abroad 17 out of 18 months, and also provide the same $20,000 ceiling with respect to those who are bona fide residents of a foreign country.

The draft retains the 17-out-of-18-months provision of present law without limiting it to underdeveloped countries. However, it provides that the bona fide residence rule of present law should be subject to a ceiling, and that earned income over some specified amount should be fully subject to U.S. tax. The dollar amount of this ceiling, however, was not established by the Committee on Ways and Means for the discussion draft.

A second recommendation of the administration in this area relates to pensions and deferred compensation paid to U.S. citizens, after they are back in the United States, but with respect to service while they were abroad.

In the case of pensions generally, an employee receives back over his period of life expectancy (or in some cases in the first 3 years) the amount he paid toward his pension. The remainder of the pension payments he receives, consisting of contributions by the employer and interest on the funds while they were accumulating, is taxable to him as the pension or annuity payments are received.

In the case of a citizen who has been a bona fide resident of a foreign country, or been in a foreign country for a period of 17 out of 18 months or more, the employer contributions toward the pension fund during the period he was abroad are treated in the same manner as his own contributions and, therefore, are not taxable to him when he draws his pension or annuity upon retirement even though he then is living in the United States.

The draft provides that these contributions by an employer will no longer be treated in effect as employee contributions. Thus, even though attributable to a period when an employee was abroad, if the employee is in the United States when the pension or annuity

is received, these contributions by the employer will be taxable to the employee in the same manner as in the case of a domestic worker also receiving a pension. The contributions by the employer will, however, retain their character as earned income with the result that if the pension or annuity is received while the former employee is still living abroad, this amount will be eligible for the exclusion.

Under the discussion draft deferred compensation will be fully subject to U.S. tax where the person is in the United States at the time the deferred compensation is received. This is accomplished by imposing the new ceiling with respect to bona fide residents of a foreign country. The Treasury has previously ruled that the $20,000 ceiling with respect to those abroad for 17 out of 18 months prevented such an arrangement in their cases. Thus, a ceiling in the case of bona fide residents abroad will have the same effect.

B. MORE SPECIFICALLY

1. *Limitation on earned income exclusion.*—The discussion draft modifies the provision of present law (par. (1) of sec. 911(a)) which excludes from U.S. tax earned income of individual citizens of the United States who are bona fide residents of a foreign country or countries for an uninterrupted period which includes the entire taxable year. The draft provides that the exclusion in this case is not to exceed some amount (not yet specified by the committee) where the individual has been abroad for the entire taxable year. If in the year under consideration the period abroad was less than an entire taxable year, then the individual is to receive an exclusion for the same proportion of the maximum exclusion for a year which the number of days in the year for which he was a bona fide resident is of the total number of days in the year.

2. *Pension income.*—A provision in present law dealing with annuities (sec. 72(f)) provides that in determining what the employee or annuitant paid for an annuity contract, there are to be included contributions of the employer, if, had they been paid to the employee in the first instance, these contributions would not have been taxable to the employee. This provision has had the effect of excluding from tax an amount equal to employer contributions to a pension plan where an employee is abroad and qualifying either under the bona fide residence rule or under the 17-out-of-18-month rule. In effect, these payments are treated as if they had been distributed to the employee as compensation and recontributed by him to the pension plan.

The discussion draft nullifies this effect by providing in the case of amounts received in taxable years beginning after December 31, 1961, that contributions made by the employer are not to be treated in the same manner as premiums paid by the employee if they are nontaxable to the employee merely because of the application of the exclusion for certain income earned abroad. (The amendment will not affect the present treatment of contributions for State and local government employees for periods before their salaries were subject to Federal income tax.)

The amendment described above, taken alone, would treat the portion of the annuity attributable to employer contribution to pension plans in the case of employees abroad as income which is subject to U.S. tax in all cases. However, a further amendment to the exclusion

for earned income abroad (sec. 911(c)) treats these employer contributions in such cases as earned income. Thus, if the individual is living abroad when the annuity or pension payment is received, such amounts, subject to the ceiling limitation, are eligible for the foreign earned income exclusion. On the other hand, if the pension is received after the employee has returned to the United States, then these employer contributions will be fully subject to U.S. tax. The proportion of any pension payment considered to be the employer contribution for the period the individual was abroad, is the proportion of the amount which would have been included in his gross income without regard to this provision which these employer contributions are of the total amount expected to be received under the annuity contract less the consideration for the contract contributed by the employee. The effect of this ratio is to continue the employee's exclusion in all cases with respect to his own contributions, to make the taxable status of the employer contributions to the extent attributable to the employee's service abroad depend upon whether he is in or out of the United States when he is receiving the pension, and to continue to treat as taxable in all cases the interest element in the annuity contract plus any employer contributions attributable to his service while in the United States.

Certain amounts not received as annuities also are under the general annuity rule. This includes amounts such as lump-sum payments received under an annuity, endowment, or life insurance contract. In the case of these payments, the individual now is treated as receiving back first, and free of tax, any amount that he contributed to the contract. Any remaining amount presently is subject to tax. The draft continues to treat as the first amount received, the amount paid by the individual. The second amount will be any contributions made by the employer while the employee was in foreign service and the third amount received will be any other amounts. Thus, if the employee, who qualified for the exclusion by reason of residence abroad, receives income treated as falling in this second category, namely, the contributions by the employer, while he is abroad, the exclusion will continue to apply as under present law. However, if such amounts are treated as being received after he is back in the United States, then they will be subject to U.S. tax.

VIII. GAIN FROM DISPOSITION OF DEPRECIABLE PERSONAL PROPERTY

(Sec. 7 of draft and secs. 1245, 167(f), and 170(e) of code)

A. IN GENERAL

Under present law in the case of depreciable property, the taxpayer may write off the cost or other basis of the property over the period of the useful life of the asset in his hands. This cost or other basis generally can be written off evenly (or in a "straight line") over the asset's life, under the declining balance method, the sum-of-the-year's digits method, or in any other consistent method which does not during the first two-thirds of the useful life of the property exceed the allowances which would have been allowed under the double declining balance method. This depreciation deduction is a deduction against ordinary income. If either the useful life of the asset is too short, or the particular method of depreciation allows too much depreciation in the early years, the decline in adjusted basis of the asset resulting from these depreciation deductions may exceed the actual decline of the value of the asset. Since the depreciation deductions in either of these cases reduce the basis of the property faster than the actual decline in the value of the asset, there will be a gain if the asset is sold. Under present law this gain is taxed as a capital gain.

The President stated that our capital gains concept should not encompass this kind of income. He indicated that this inequity should be eliminated, especially in view of the proposed investment credit.

The draft in general treats as ordinary income any gain on the sale of certain depreciable assets to the extent of the depreciation deductions taken. Under this provision, however, such treatment will apply only in the case of depreciable personal property. This treatment is not applied to real property. Under the draft this provision also is to have only a prospective application. Therefore, in determining the amount of any gain to be treated as ordinary income, only depreciation occurring in 1961 and subsequent years is to be taken into account.

Because of the assurance this provision provides of recapturing excessive deductions as ordinary income, the draft provides more lenient rules in determining salvage value. It provides that the amount which the taxpayer may depreciate over the expected useful life of an asset in his hands need not be reduced for the remaining value of the asset, if this salvage value does not exceed 10 percent of the cost or other basis of the property. In addition, for a period of time after the new ordinary income treatment becomes applicable, taxpayers will have a new election to change their method of depreciation with respect to personal property to which the ordinary income treatment applies. This will enable them to elect a more conservative method of depre-

ciation if they wish to escape the chance of any excessive depreciation deductions which might otherwise lead to ordinary income upon the sale of the asset.

The above description has been in terms of the sale or exchange of a depreciable asset. There are also other methods of disposing of an asset which are dealt with by this provision. In the case of a gift or a transfer at death no gain is recognized at the time of the disposal of the asset. In the case of a gift, however, the ordinary income potential of the depreciation deductions carries over into the hands of the donee. In the case of gifts to charity, although no ordinary income is recognized at the time of the gift, the charitable contribution is reduced by the amount which would be recognized as ordinary income if the property were sold. Generally, in other cases any gains which under present law would be recognized at the time of the disposition of an asset will be treated as ordinary income to the extent of any depreciation deductions taken. In certain cases, however, in order to prevent tax avoidance it has also been found necessary to recognize ordinary income on the disposition of an asset even though gain might not otherwise be recognized. This is true in certain cases where a distribution is made by a corporation or partnership. These and other provisions where ordinary income may be recognized are described in the more specific explanation below.

B. MORE SPECIFICALLY

1. *General rule.*—The general rule (in sec. 1245) provides that ordinary income is to be recognized in the case of sales or exchanges to the extent the so-called recomputed basis, or amount realized in the sale or exchange, whichever is lesser, exceeds the adjusted basis of the property in the hands of the person making the sale or exchange. "Recomputed basis" is defined generally as adding back to the adjusted basis the depreciation deductions previously taken. The excess of the amount realized over the adjusted basis is, of course, the amount presently recognized as capital gain. Since the rule requires that the smaller of these two amounts be treated as ordinary income, this in effect means that the ordinary income in the usual case is to be the gain realized or depreciation deductions taken, whichever is the smaller. Where there is a disposal of an asset without a sale, any gain recognized is to be determined by reference to the fair market value of the asset.

Since this provision is to have prospective application only, in computing depreciation for this purpose only depreciation deductions occurring in taxable years beginning after December 31, 1960, are to be taken into account. Depreciation deductions for this purpose include not only regular depreciation deductions but also the first-year depreciation allowance deduction and any deduction for the amortization of emergency facilities. The depreciation deductions taken into account are not limited to those taken by the taxpayer, but also include deductions taken by others from whom the taxpayer acquired the property, if the basis of the property was carried over from the person from whom the taxpayer acquired it. This would not be true, where the taxpayer acquired the property from another by reason of the latter's death, since in this case the property receives a new basis at death. Although generally the reduction in basis of

property is never less than the amount "allowable," a special rule provides that the depreciation deductions taken into account for the purposes of this provision will be the amount "allowed" rather than those "allowable" where the taxpayer can establish that the former amount is less than the amount "allowable."

The type of property receiving the ordinary income treatment described above is depreciable personal property other than livestock. Livestock for this purpose is not limited to draft, dairy, or breeding animals. This provision applies to taxable years beginning after December 31, 1960, and ending after August 1961.

2. *Exceptions.*—Except as specifically provided in the draft, the ordinary income treatment applies any time property is disposed of. The draft, however, provides six general categories of exceptions to this rule. The first exception is for gifts. As pointed out above, however, deductions by the donor must be taken into account by the donee, and may result in ordinary income to him, if he sells the property. In the case of depreciable property which is given to a charitable organization, although no income is realized by the donor at the time of the gift, the amount of the charitable contribution deduction he may receive is reduced by the amount which would have been treated as ordinary income had the property been sold at its fair market value (this is done by an amendment adding a new sec. 170(e)).

A second exception to the realization of ordinary income upon the disposition of depreciable personal property is provided in the case of transfers at death (except where the sale has occurred before death and the income is treated as income in respect of a decedent under sec. 691). In this case, however, there is not a carryover to the decedent's legatee or heir of the income potential in the depreciation deductions of the deceased.

A third category of exceptions to the realization of ordinary income is provided in the case of a series of transactions which generally are tax free. However, in these transactions where there is any gain recognized, because the exchange is accompanied by "boot" (i.e., money or its equivalent) then to the extent of this gain, ordinary income may be recognized to the extent of the depreciation deductions. The tax-free transactions referred to relate to those occurring upon the complete liquidation of a subsidiary (sec. 332); in the case of a transfer for stock or securities to a corporation controlled by the transferor (sec. 351); in the case of a transfer by a corporation which is a party to a reorganization of property in pursuance of a plan of reorganization solely for stock or securities in another corporation also a party to the reorganization (sec. 361); and in the case of reorganizations in certain receivership and bankruptcy proceedings (sec. 371(a) and sec. 374). Also included in the same category are contributions of property to a partnership in exchange for an interest in the partnership, and distributions by a partnership in partial or complete liquidation of an interest (but in this respect see the special partnership treatment described below). Despite the above rule there would be a recognition of ordinary income where there is a contribution of depreciable property to a tax-exempt organization (other than a tax-exempt farm cooperative) in exchange for stock or securities in the exempt organization. Recognition of ordinary income in this case is provided because a disposition of the property

by the exempt organization would not give rise to the realization of ordinary income with respect to the depreciation deductions.

Another exception is provided in the case of so-called like kind exchanges of property used for production or investment, and for involuntary conversions. In exchanges of these types, the ordinary income realized is limited to any gain recognized, plus the fair market value of property acquired in exchange for depreciable property where the property received is nondepreciable or other nonqualifying property. The realization of ordinary income (to the extent of the depreciation deductions) is provided in such cases since in the case of property, other than depreciable personal property, there is no opportunity for subsequent recovery of the ordinary income element. A similar exception is provided in the case of the exchange or sale of property in obedience to Federal Communications Commission orders or orders of the Securities and Exchange Commission (secs. 1071 and 1081). In these cases also, the ordinary income realized is limited to the gain recognized, plus any unrecovered depreciation charges with respect to exchanges of depreciable personal property for other types of property.

Special rules are also provided in the case of distributions of depreciable personal property by a partnership to a partner. A distribution of depreciable personal property by a partnership to a partner to the extent that the distribution accounts for the partner's own share of gain attributable to this property is not to result in ordinary income at the time of the distribution. However, the ordinary income potential of depreciation deductions taken by the partnership (or by any earlier transferor from whom the partnership acquired property without realization of gain) will be carried over to the distributee partner. When he disposes of this property the ordinary income potential of these partnership (or prepartnership) depreciation deductions will be taken into account in a manner substantially the same as that applying where the taxpayer himself took the depreciation deductions. The property distributed is given a "recomputed basis" at the time of the distribution to the partner equal to the basis of the property in the hands of the partner minus any ordinary income gain on which the partnership would have been taxed had the property been sold by it (at its fair market value) immediately before the distribution.

The rule described above applies only to the extent a partner is considered as receiving his own share of the property representing ordinary income gain. An amendment made elsewhere to the code (sec. 751(c)) provides that in other cases the ordinary income element in depreciable property is to be considered as a "unrealized receivable." Thus to the extent of depreciation deductions taken (or potential gain if smaller) ordinary income will be realized (either to the transferee or transferor) in the case of the sale of a partnership interest, in the case of a distribution to a retiring or deceased partner, and in the case of distributions to a partner where he receives either more or less than his proportionate share of property reflecting this type of gain.

3. *Dispositions resulting in ordinary income where no gain is presently recognized.*—In a series of situations the draft recognizes ordinary income even though no gain in such situations is recognized under existing law. This was done primarily in those cases where the

transferee receives the property at a basis other than that of the transferor. This treatment is provided in three cases where a distribution is made by a corporation without the payment of a tax at the corporate level on unrealized appreciation in value: namely, where the property is distributed as a dividend (under sec. 301), where the property is distributed in a partial or complete liquidation by a corporation (sec. 336), and where in a plan of complete liquidation a corporation sells the depreciable personal property and perhaps other assets and within a 12-month period completes the liquidation of the corporation (sec. 337).

Other situations where ordinary income may be realized under this provision, although no gain would otherwise be realized, include the case where a distribution is made by a partnership and the partner gives up, or acquires, more than his proportionate share of this property. Also involved are the provisions relating to the exchange of "like kind" property, involuntary conversions, sales or exchanges to effectuate FCC policy, and exchanges in obedience to orders of the SEC. In all of these cases to the extent the property received in exchange for depreciable personal property is not itself depreciable personal property, the ordinary income treatment applies.

4. *Salvage value.*—The draft also amends the code (a new subsec. (f) in sec. 167) to provide that in computing the basis on which depreciation may be taken for personal property, salvage value may be ignored to the extent of an amount equal to 10 percent of the cost or other basis for the property. Thus, if the expected salvage value equals 8 percent of the basis of the property, the entire basis may be written off in depreciation charges by the taxpayer. If the expected salvage value is 12 percent, all but 2 percent of the basis of the property can be taken into account in computing depreciation charges. This provision applies to depreciable personal property (other than livestock) with a useful life of 3 years or more acquired after August 1961.

5. *Change in method of depreciation.*—It is recognized that some taxpayers who have been following liberal depreciation policies may desire to follow more conservative policies as a result of the ordinary income treatment provided where depreciation has been taken. Therefore, the draft provides that a taxpayer may elect to change his method of depreciation with respect to depreciable personal property. The right to make this election will be available for a period to be specified by the Secretary of the Treasury, after the regulations on this provision have been issued.

IX. TAX TREATMENT OF COOPERATIVES AND PATRONS

(Sec. 8 of the draft and secs. 1381 to 1388 of the code)

A. IN GENERAL

In 1951 Congress passed legislation which, taken together with prior Treasury rulings, it generally was thought insured that earnings of cooperatives would be taxable (to the extent they reflected business activity) either to the cooperatives or to the patrons. However, certain court decisions, notably *Long Poultry Farms, Inc.* (249 F. 2d 726; C.C.A. 4 (1957)) and *B. A. Carpenter* (219 F. 2d 395; C.C.A. 5 (1955)), held that noncash allocations of patronage dividends generally were not taxable to the patron, although they were deductible by the cooperative.

The President recommended that what was thought to be the law in 1951 be provided specifically in the statute. Under the recommendation cooperatives would be allowed to deduct amounts allocated in cash or scrip as patronage dividends and patrons would be taxable on the patronage dividends allocated to them arising out of business activities.

The draft follows an approach which is similar to that recommended by the President. It provides that the cooperative may deduct patronage dividends paid in money, "qualified scrip," or other property except nonqualified scrip. A deduction is also provided for nonqualified scrip when it is redeemed. For the patron, the draft provides that these same amounts (to the extent not attributable to purchases of personal, living or family items) are to be included in their income for tax purposes. "Qualified scrip" for this purpose is defined by the bill as including scrip which the patron can redeem in cash at its stated dollar amount any time in the first 90 days after it is issued. Also, in the case of farmers' cooperatives (whether or not exempt) "qualified scrip" also includes scrip which the farmer patron has consented in writing to take into account at its face amount as income for tax purposes. Since in the case of the 90-day scrip or consent scrip each individual patron has the opportunity either to draw his dividends out of the cooperative in cash or to leave the dividends in the cooperative—that is, to constructively receive the dividend and reinvest it—it is clear (where the patronage dividend arises from business activity) that it constitutes income to the patron and therefore may be taxed to him.

This amendment is effective for taxable years beginning after December 31, 1961, in the case of the cooperatives, and in the case of patrons is effective with respect to amounts paid by the cooperatives in taxable years of the cooperative beginning after that date. Existing law will continue to apply with respect to scrip (including its redemption after the specified date) issued in earlier taxable years to which the new provisions do not apply.

B. MORE SPECIFICALLY

1. *Cooperatives covered by provision.*—The tax treatment outlined here applies to the so-called tax-exempt farmers' cooperatives, to other farm cooperatives, to consumer cooperatives, and also to other corporations operating on a cooperative basis. The provision does not, however, apply to mutual ditch, irrigation, or REA cooperatives, to mutual savings banks, building and loan associations, etc., or to mutual insurance companies.

2. *Patronage dividends.*—The draft provides specifically that the gross income of the cooperatives is to be determined with patronage dividends included in it. However, a deduction is allowed for patronage dividends which are paid in money, qualified scrip, or other property (except nonqualified scrip). A deduction also is allowed for patronage dividends paid in nonqualified scrip when it is redeemed in cash or other property (except other scrip).

An exempt farmers' cooperative is allowed a deduction for patronage dividends paid during a year out of patronage earnings from that year or from prior years. Other cooperatives, to obtain a deduction for patronage dividends, must pay the dividend during the year in which the patronage occurred. In both cases, however, there is a grace period after the close of the year during which the cooperative can pay patronage dividends which will be considered as having been paid during the year. For the exempt farmers' cooperatives, this grace period is 8½ months; for the other cooperatives, the grace period ends when the cooperative's tax return must be filed for the year (taking into account any extensions of time for filing). In the case of pooling arrangements extending over more than 1 year, the patronage is considered as occurring in the year in which the pool closes.

3. *Qualified scrip.*—Scrip must be issued in the form of capital stock, revolving fund certificates, certificates of indebtedness, or other written notices which indicate to the recipient the dollar amount allocated to him by the cooperative. For the scrip to be qualified scrip (and therefore deductible with respect to the year it is issued rather than the year it is redeemed) one of two conditions must be met. It may be scrip where the patron for a 90-day period beginning with the date the scrip is paid has the opportunity to redeem the scrip in cash for the stated amount of the patronage dividend. An alternative qualifying rule is provided for farmers' cooperatives. Under this alternative the patron must give written consent to have the scrip treated as a distribution to him which he will take into his income for tax purposes (if the patronage arises from a business activity). Moreover, this consent must be given annually (or more often) by the patron. By this written consent the patron has in effect constructively received the patronage dividend and reinvested it in the cooperative.

This consent alternative is available not only to the so-called tax-exempt farmers' cooperatives, but also to other farmers, fruitgrowers, and like associations which market the products of members or other producers or purchase supplies and equipment for members or other persons. However, in the case of a marketing cooperative, 50 percent or more of the value of the products marketed must be for members. Similarly, in the case of the purchasing cooperatives, 50 percent or more of the value of the supplies and equipment purchased must be

for members, and in the case of purchases for nonmembers, purchases for other than producers may not exceed 15 percent of total. In determining these ratios of purchases or sales, business done for the U.S. Government will not be taken into account. These rules as to what constitute a farmers' cooperative are included among the requirements of an "exempt" farmer's cooperative but do not represent all of the requirements an exempt cooperative must meet.

4. *Additional deduction for "exempt" farmers' cooperative.*—In addition to deducting patronage dividends, the so-called exempt farmers' cooperative as under present law is permitted a deduction for amounts paid out as dividends on its capital stock. It also receives a deduction for amounts paid in money, qualified scrip, or other property (except nonqualified scrip) paid to its patrons on a patronage basis where the earnings involved are derived from business done for the U.S. Government or from sources other than patronage (such as investment income).

This deduction (except that in the case of payments made in the form of scrip, the deduction is limited to qualified scrip) is the same as that provided by existing law. Amounts paid during the year in the redemption of nonqualified scrip also are available to these exempt cooperatives as a deduction under the draft.

5. *Treatment of patron.*—With the exceptions referred to below, under the draft the patron is required to take into income the patronage dividends paid in money, qualified scrip, or other property and the amount he is required to take into his income is the same as that which is currently deductible to the cooperative; namely, in the case of qualified scrip, its stated face amount and, in the case of other property (except nonqualified scrip), its fair market value. The patron also is required to take into income any nonqualified scrip which is redeemed. These amounts are taken into the patron's income in the year in which they are received by him, or in the latter case in the year in which the redemption occurs.

Generally, the effect of the treatment specified above for patrons, taken together with that also outlined above for cooperatives, is to obtain a single tax with respect to the income of the cooperative, either at the level of the cooperative or at the level of the patron. However, this rule will not apply in the case of patronage dividends paid with respect to purchases of personal, living, or family items. In such cases, there is to be no inclusion in the income of the patron with respect to the patronage dividends. This is in accord with the concept that patronage dividends represent price adjustments. Therefore, under this concept the patronage dividends in these cases represent downward price adjustments of personal, living, or family items and should no more lead to taxable income than bargain purchases of such items elsewhere.

An exception to the rule for inclusion of the patronage dividends in income is also made for patronage dividends attributable to purchases of depreciable property or capital assets. In such cases the patron is not required to take the dividend into income since it in effect represents an adjustment in the price paid for these articles and therefore is reflected in their cost or basis. However, the lower basis for the property in the case of depreciable property will mean smaller depreciation deductions or in the case of capital assets (and depreciable assets) will result in a larger gain upon sale.

6. *Effective date.*—Generally, the draft applies to taxable years of the cooperatives beginning after December 31, 1961. For the patrons these provisions are to apply with respect to amounts received from a cooperative if the amount which is paid by the cooperative is with respect to patronage which at the cooperative level is also subject to the new rules. Existing law continues to apply with respect to patronage dividends paid before the date specified above and also with respect to redemptions of patronage dividends after that date if the scrip involved was actually issued with respect to an earlier period.

X. WITHHOLDING ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

(Sec. 9 of the draft and secs. 3451–3491 and 39 of the code)

A. IN GENERAL

The President in his tax message to Congress proposed that one-fifth, or 20 percent, of interest, dividends, and patronage dividends be withheld from the recipients and paid over to the Government as a partial payment of the recipient's tax on this income. The discussion draft provides for the withholding of one-sixth, or 16⅔ percent, of interest, dividend, and patronage dividend payments. The draft also provides an exemption certificate procedure for individuals having no tax liability and also a quick refund procedure in cases where there is overwithholding.

B. MORE SPECIFICALLY

The draft provides that payors of interest, dividends, and patronage dividends, with certain exceptions noted below, are to withhold one-sixth (or 16⅔ percent) of the payment they would otherwise make to the interest, dividend, or patronage dividend recipient. This withheld amount is to be paid over to the Government by the payor by the last day of the first month after the end of the calendar quarter (April 30, July 31, October 31, or January 31) to which the withholding relates.

The recipient of the interest, dividend, or patronage dividend payment when he files his income tax return can claim credit for the payment made by the payor on his behalf. This withholding system does not require the attachment of any receipt by the recipient of the payment to his tax return (sec. 3490 provides a presumption that amounts have been withheld). It also does not require the payor to send the income recipient any receipt. Instead, it is presumed that, initially at least, payors will indicate in some communication to the recipient of the payment that the payment is "net," that is, reduced by one-sixth for the amount withheld for the Government.

It is contemplated that the recipient of the payment on his tax return first will report the net interest, dividend, or patronage dividend payment received. He will then be requested to add to this amount one-fifth of the amount received, representing the amount withheld. This is what is referred to as "grossing up" the interest or dividend payment. Thus, for example, if an individual were entitled to $100 of dividends before withholding, one-sixth of this amount, or $16.67, would be withheld by the payor and remitted to the Government. The remainder, or $83.33, would be the net dividend payment received by the recipient. This is the amount he would initially report on his income tax return. He would be asked to add to this one-fifth of this amount, or $16.67, bringing the total back to the full $100 dividend payment. He would then compute his income tax in the usual

manner. Finally, the tax otherwise owed would be reduced by the amount withheld with respect to this dividend payment, namely, the $16.67.

Under the draft, provision is made for exemptions from withholding in certain cases and also for quick refunds where no tax is owed or there is overwithholding. In addition, no withholding is provided in the case of certain types of interest and other payments.

The withholding provisions generally are to be effective with respect to interest and dividend payments made after January 1, 1962. In the case of patronage dividends, the withholding provisions will apply to patronage occurring in the first taxable year of the cooperative beginning after January 1, 1962.

1. Definition of interest, dividends, and patronage dividends

The bill defines interest, dividends, and patronage dividends in fairly broad terms and then specifies certain exceptions. The definitions are described immediately below; the discussion of the exceptions then follows.

(*a*) *General definition of interest.*—The definition of interest provided by the draft for the most part is limited to payments made by corporations where the holder of the indebtedness is likely to be an individual (although not necessarily actually so in any given case). In addition, where non-interest-bearing obligations are issued on a discount basis, no attempt is made to withhold on the payments received at the time of the redemption of the obligation (except in the case of savings bonds). Withholding is not provided in such cases because of differences in the tax treatment of original issue discount where the obligation is held to maturity by the initial holder and where it is acquired before that time by a subsequent purchaser.

In more specific terms, the draft includes within the definition of interest, to which withholding is applied, seven different categories of interest:

(1) Interest on evidences of indebtedness (such as bonds, debentures, notes, and certificates) issued by a corporation with interest coupons or in registered form. In addition, there is included interest on other types of indebtedness issued by a corporation where the instrument is of a type generally offered by corporations to the public, but only to the extent so provided by regulations issued by the Treasury Department. This will not include interest on mortgage paper generally, since mortgages usually are not of a type offered by corporations to the public.

(2) Bank account interest.

(3) So-called dividend payments made by mutual savings banks, savings and loan associations, building and loan associations, cooperative banks, homestead associations, credit unions, etc.

(4) Interest on amounts held by insurance companies under an agreement to pay interest. This does not include policyholder dividends. The withholding occurs at the time the amounts otherwise are required by law to be reported as income.

(5) Interest on deposits with stockbrokers.

(6) Interest on obligations of the United States. This generally does not include any obligations issued as a discount, such as Treasury bills (but see category 7 below for an exception).

(7) Non-interest-bearing obligations of the United States issued at a discount and having a maturity of more than 1 year from the date of issue. This is primarily interest on series E savings bonds.

(*b*) *General definition of dividends.*—The definition of a dividend for purposes of the withholding tax is the same as that provided by the code for other purposes (as defined in sec. 316). However, in addition, "dividends" are defined as including payments made by stockbrokers as substitutes for dividends. Thus, where an individual has sold stock short, his broker may have borrowed stock for him from another person to cover his short sale. If a dividend becomes payable during the period of the loan of the stock, in such a case the stockbroker must make a payment to the person from whom the stock was borrowed as a substitute for the dividend he would otherwise receive (and obtain reimbursement for this payment from the person to whom the loan of the stock was made). Under the draft such a substitute payment by a stockbroker is treated as if it were a dividend for purposes of withholding.

(*c*) *General definition of patronage dividends.*—In the case of patronage dividends withholding will apply to those paid in money, in qualified scrip, and in other property except nonqualified scrip. (See IX–B–(3) for discussion of qualified scrip.) In addition, in the case of the so-called exempt farmer's cooperative, withholding is to apply to amounts not representing patronage dividends where the amounts are paid to patrons in money, qualified scrip, or other property (except nonqualified scrip) if the payment is made on a patronage basis and the earnings involved are derived from business done with the United States or from sources other than patronage (such as investment income).

(*d*) *General exceptions where withholding does not apply.*—The draft provides certain exceptions to the definitions of interest, dividends, and patronage dividends subject to withholding. The exceptions which relate only to interest and not to dividends and patronage dividends and vice versa are described below. The three exceptions which are common to all three categories are discussed here.

In the case of all three categories of payments the draft provides that no withholding is to occur with respect to amounts paid from one corporation to another where both are members of the same affiliated group and where a consolidated return is filed for income tax purposes. In such cases these intercompany transactions are "washed out" for tax purposes.

A second group of payments to which withholding is not to apply in the case of any of these three types of payments are those made to nonresident aliens and foreign corporations where there already is a special form of withholding under present law, or where there would be but for the provisions of a treaty or the fact that the income is not considered as income from sources within the United States.

A third group of payments to which withholding will not apply are interest, dividend, or patronage dividends paid by foreign corporations not engaged in trade or business within the United States. The corporation in such cases is not subject to U.S. jurisdiction although income received from it by a U.S. citizen or resident may be subject to U.S. tax.

(*e*) *Special exceptions for interest.*—In the case of interest payments, exemptions from withholding are also provided for—

(1) Tax-exempt State and local obligations since these are not subject to income tax.

(2) Amounts paid by a foreign government, international organization, nonresident alien not engaged in a trade or business here, or a partnership not engaged in a trade or business here and composed in whole or in part of nonresident aliens. (An exception for foreign corporations not in business here was previously noted.) In such cases the payor is not subject to U.S. jurisdiction although income received from it may be subject to U.S. tax in the hands of a U.S. citizen or resident.

(3) Bank account interest paid to the foreign governments, foreign corporations, nonresident aliens, foreign partnerships or international organizations (limited as described above). In this case the income is not subject to U.S. tax.

(4) Amounts paid with respect to tax-free covenant bonds. The payor in such a case is required to pay the tax.

(5) Amounts paid with respect to deposits in school savings accounts to the extent provided by regulations. In such cases the exemption in general will be limited to children, the great bulk of whom would in any case owe no income tax.

(6) Amounts paid by a U.S. agency or instrumentality to another U.S. agency or instrumentality if the Secretary of the Treasury determines that the withholding in this case represents an unnecessary burden. In this case also no tax would be due.

(*f*) *Special exceptions for dividends.*—In the case of dividends, the additional exceptions where withholding is not to apply are as follows:

(1) Amounts paid in stock or stock rights where the distribution is not includible in the income of the recipient.

(2) Any distribution where the recipient treats the amount received as a capital gain or recognizes no gain or loss.

(3) Amounts which, even though includible in the income of the recipient, are treated as redemptions of stock (sec. 302), dispositions of section 306 stock, additional consideration in connection with certain reorganizations (sec. 356), or distributions pursuant to an SEC order (sec. 1081(e)(2)).

(4) Amounts treated as dividends of corporations electing subchapter S treatment (treatment similar to partnerships).

(5) Amounts paid under a lease entered into before 1954 where the shareholders of the lessor corporation are entitled to the amounts without deduction for any U.S. tax.

(*g*) *Special exceptions for patronage dividends.*—In the case of patronage dividends, in addition to the exceptions previously noted, where the Secretary of the Treasury determines that a cooperative is primarily engaged in selling at retail goods or services which are generally for personal, living, or family use, an exemption from withholding may be provided. Patronage dividends in this case are not includible in the income of the recipient and, therefore, need not be subject to withholding.

2. Exemption certificates and intra-annual refunds and credits

To prevent hardships in the case of those who owe no tax on their interest, dividends, or patronage dividend payments, or who are sub-

ject to overwithholding, the draft contains a series of provisions providing for exemption from withholding or refunds or credits of the withholding tax. These provisions are discussed below. First, there is presented those provisions applicable in the case of individuals. This is followed by discussions of the provisions applicable to governmental units and tax-exempt organizations, to corporations generally, and finally to nonresident aliens.

(*a*) *Individuals.*—In the case of individuals, interest, dividend and patronage dividend withholding is not to apply where the individual files an exemption certificate with the payor of the dividend or interest, certifying that he reasonably believes he will not be liable for the payment of any income tax for the year in question (sec. 3483). These exemption certificates must be filed with the dividend or interest payor once a year. They may be filed with respect to bank account interest, patronage dividends, and dividend payments, but not with respect to corporate or Government bond interest (other than savings bonds referred to below). An exception had to be made for corporate and Government bond interest because of the difficulty of making exemption certificates work where these bonds are transferred from one holder to another between interest payment dates, where one such holder might be exempt and the other not. The exemption certificates apply in the case of series E savings bonds but instead of filing one exemption certificate a year in such cases, a separate exemption certificate is required to be filed with respect to each transaction in which these bonds are cashed in. This is necessary since these bonds may be cashed at different places.

The draft provides that anyone who willfully files an exemption certificate, knowing the certification to be fraudulent or false, is to be fined not more than $500 or imprisoned for not more than 1 year, or both.

In addition to the exemption certificates described above applicable where there is no tax liability, the draft provides for quarterly refunds payable during the year, where there is tax liability but the withholding is expected to be excessive. In the case of wage withholding it is possible for the payor to take into account directly the personal exemptions of the taxpayer. However, in the case of dividend, interest and patronage dividend withholding, both because there is a much greater chance of multiple payors and also because of the greater likelihood of the purchase or sale of stock during the year, no system of having the payor take exemptions into account appears feasible. However, in the draft much the same effect is achieved by a quarterly refund system. Under the draft, quarterly refunds are available only to single persons expecting a gross income of less than $5,000 and married individuals and heads of households expecting a gross income of less than $10,000 a year. These quarterly refunds in no case, however, are to be available for dependent children. (For treatment of refunds in their cases, see discussion below.)

Taxpayers whose gross income is expected to be below the specified amount may file one refund claim each quarter (at any time during the quarter they see fit). This claim may request a refund for any withholding of interest, dividends, or patronage dividends up to the amount of the taxpayer's "refund allowance." His "refund allowance" is 20 percent of his expected deductions for personal exemptions plus 20 percent of his expected retirement income, less 20 percent of

any other income he expects to receive which is not subject to dividend or interest withholding. A subtraction must also be made for any refunds received in earlier quarters during the year. In effect this grants the taxpayer an exemption from withholding for his personal exemptions and retirement income credit similar to the exemption provided through employers for wage withholding.

Actually the taxpayer generally will need to file such a claim for refund only in the first quarter. In the second and third quarters it is expected that the Internal Revenue Service will compute a tentative refund, based upon the information the taxpayer previously submitted. This procedure can be followed in all cases where the taxpayer indicates his income status has not changed significantly from his prior expectations. For the fourth quarter the refund is to be claimed on the regular tax return of the individual which he may file immediately after the end of the year.

To minimize small adjustments, the draft provides that the intra-annual refund claims may be filed only for amounts of $10 or over. However, where the excess withholding for one quarter may be below $10 but the cumulative amount for two or more quarters is above $10, an intra-annual refund is permitted.

In addition to the use of exemption certificates and intra-annual refunds as outlined above, taxpayers required to file declarations of estimated tax may take credit on such declarations for amounts withheld with respect to interest and dividends in the same manner as they presently do in the case of wage and salary withholding (sec. 6015). In addition, an ordinary annual refund claim may be made with respect to excessive withholding on interest and dividends as is presently true of wage withholding (see amendment to sec. 6401).

One further type of crediting is also provided by the draft. This relates to withholding on interest, dividends, and patronage dividends received by dependent children of the taxpayer. In such cases, if the child has not separately filed a claim for refund, and the child's gross income is less than $600 and is not subject to any wage withholding, then the parent of the child may, on the parent's return, claim a credit for the amount of the withheld tax with respect to the child's interest, dividend, or patronage dividend.

(*b*) *Governmental units and tax-exempt organizations.*—In the case of State and local governments and tax-exempt organizations (other than cooperatives) the draft provides that the Government or organization may offset the withholding on dividends and interest income it receives against the amount it is required to withhold with respect to its employees for social security and Federal income tax purposes (sec. 3505).

In addition, refunds may be claimed in the case of these State or local governments or tax-exempt organizations (other than cooperatives) for amounts not credited in the manner described above against social security or wage withholding taxes. These refunds may be made to the governmental unit or exempt organization on a quarterly basis during the year of liability. Quarterly refunds may also be filed by the U.S. Government and by foreign governments or international organizations and foreign central banks of issue (to the extent the income on which the withholding occurs in the latter case is not derived from any commercial banking functions (sec. 3485)).

(*c*) *Corporations generally.*—Because of the 85 percent intercorporate dividends received deduction, any net tax on dividends

received by corporations is likely to be less than 8 percent. In addition to the low rate of tax applicable, there has been little difficulty in collecting this tax. In view of these considerations, the draft permits the crediting or refunding of the entire amount withheld in the case of amounts received by corporations.

First, in the case of corporations, any amount withheld on interest and dividend payments received by them can be claimed as credits against the tax they are required to withhold with respect to their own dividend and interest payments (sec. 3487). For this purpose, withholding on interest and dividends received by one corporation may be claimed as credit against interest or dividend payments made by another corporation which is a member of the same affiliated group.

Any amount withheld with respect to interest and dividends received by a corporation in excess of the credits it claims with respect to its own withholding on interest and dividends may be refunded to the corporation on a quarterly basis (during the year of liability) (sec. 3486). In addition, for purposes of an estimated tax required of a corporation, any amount withheld (which is not credited or refunded as provided above) may be treated as a payment of the corporation's estimated tax (sec. 6655(f)).

(*d*) *Nonresident aliens and foreign corporations in the case of nominees.*—The withholding rates applicable to nonresident aliens and foreign corporations may be 30 percent, if no special treaty provision applies, or may range down to zero percent under some treaty provisions. As a result, the withholding rate applicable in these cases may be either above or below the 16⅔ percent applicable under this draft to domestic dividend and interest payments. Where the dividend or interest payor makes the payment directly to the nonresident alien or foreign corporation, as under present law, he can apply the proper withholding rate. However, under present law where the interest or dividend payor makes the payment to a nominee, the latter withholds the appropriate amount.

Under the draft no special problem exists where the applicable withholding rate with respect to the nonresident alien or foreign corporation exceeds the 16⅔ percent domestic withholding rate. In such cases where the nominee is the withholding agent he needs only to withhold the additional amount. A problem does exist, however, where the applicable withholding rate is less than the domestic 16⅔ percent rate. In such cases the draft provides that the nominee may notify the disbursing agent from whom he receives the payment that the amount is going to a nonresident alien or foreign corporation and supply the pertinent information as to the withholding rate, etc. In such cases the dividend or interest payor withholds the appropriate amount (sec. 1444). However, where the nominee continues to serve as the withholding agent and pays the additional amount to the nonresident alien or foreign corporation (where the applicable withholding rate is below the 16⅔ percent domestic rate), then with respect to this amount which the nominee temporarily pays from his own funds, a credit may be claimed. This credit may be applied by the nominee against his liability to withhold amounts where the applicable foreign withholding rate is above the domestic rate. To the extent that funds are still owing the nominee, the excess may be claimed quarterly as a refund (sec. 3488).

3. Obligations sold between interest payment dates

Where an interest-bearing bond or other obligation is sold or exchanged between the interest payment dates, the draft provides that the amount withheld is to be treated as divided between the seller and the purchaser (or transferor and transferee) in proportion to the time (with respect to which the interest relates) which each holds title to the obligation. It is anticipated that the buyer and seller in such cases will take this treatment into account in the price at which the bond is sold. Thus, in the case of a $100 interest payment where the seller of the obligation has held the bond for half of the interest payment period in question, he presumably will demand $8.33 less than he otherwise would from the purchaser of the bond, since he knows that at the time of reporting his income for tax purposes he may claim a credit equal to this amount. Thus, he will demand of the purchaser one-half of the "net" interest (other factors being equal), or one-half of $83.33; namely, $41.67. This, plus the $8.33 for which he can claim a credit, will provide him with one-half of the interest for the period he held the obligation.

XI. INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

(Sec. 10 of the draft and secs. 6038 and 6046 of the code)

A. IN GENERAL

The administration in presenting the details of its tax proposals relating to foreign income requested fuller information relative to U.S. shareholders in foreign corporations. The draft provides such information by requiring the wider filing of existing information returns. An annual information return now required of domestic corporations controlling foreign corporations will also be required of individual citizens or residents controlling foreign corporations. Also an information return now required of officers, directors, and significant shareholders of foreign corporations upon their creation, organization, or reorganization, will also in the future be required of persons when they become officers, directors, or shareholders.

B. MORE SPECIFICALLY

1. *Annual information return.*—In 1960 (Public Law 86–780) Congress enacted legislation providing that domestic corporations must furnish with respect to foreign corporations which they control and with respect to foreign subsidiaries of any such foreign corporations, information specifying—

(1) The name, place, and nature of business of the foreign corporation and country of incorporation;

(2) The accumulated profits of the foreign corporation or subsidiary, including items of income, deduction, and other items taken into account in computing these accumulated profits;

(3) A balance sheet of the foreign corporation or foreign subsidiary;

(4) Transactions between the foreign corporation or foreign subsidiary and (a) other foreign corporations or foreign subsidiaries controlled by the domestic corporation, (b) the domestic corporation or (c) any shareholder owning at least 10 percent of the stock of the domestic corporation; and

(5) A description of the various classes of stock outstanding and name and address and number of shares held by each citizen or resident of the United States and domestic corporation holding 5 percent or more of the stock of the foreign corporation or foreign subsidiary.

For corporations failing to supply the information required, reductions in the foreign tax credit otherwise available with respect to income derived from such foreign corporations or their subsidiaries was provided.

This draft amends this information provision to require U.S. citizens or residents, as well as domestic corporations, controlling the foreign

corporations to supply such information with respect to foreign corporations and their foreign subsidiaries. Control for this purpose is more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock.

The draft also extends somewhat the type of foreign corporation with respect to which information must be supplied. Existing law applies to foreign corporations controlled by Americans and subsidiaries which they control. In other words, it applies to two levels of ownership of foreign corporations. The draft extends the requirement to apply to any number of levels of ownership so long as there is control of the corporations involved.

2. *Information from officers, directors, and principal shareholders.*—Present law also requires that U.S. citizens or residents who are officers or directors of a foreign corporation within 60 days after its creation, organization, or reorganization, and also U.S. shareholders of such corporation who within the same 60-day period own 5 percent or more of the value of the stock of the corporation, supply information with respect to this corporation. The return required is to contain such information as the Secretary of the Treasury or his delegate prescribes by forms or regulations as necessary to carry out the provisions of the income tax laws.

Under present law, it is possible to avoid this information requirement where the U.S. citizen or resident becomes an officer, director, or owner of 5 percent or more of the value of the stock of the corporation after the 60-day period. To prevent this avoidance of the information requirement, the draft extends the requirement for supplying the information referred to above so that it applies not only to those who are officers or directors of the corporation or stockholders with more than a 5-percent interest at any time within 60 days after the creation, organization, or reorganization of the corporation, but also those U.S. citizens or residents who hold such positions on January 1, 1962, or who acquire such positions after that date. This information also is to be supplied with respect to each U.S. citizen, resident, or domestic corporation which on January 1, 1962, owns 5 percent or more in value of the stock of the foreign corporation or whose holdings after that time are increased to 5 percent (or where they acquire an additional 5 percent of the stock of the corporation).

APPENDIX A

TENTATIVE TREASURY DRAFT OF ITS PROPOSED TAX HAVEN LEGISLATION

(Not a section of the committee draft; secs. 951–959 of the code)

The Treasury Department presented to the Committee on Ways and Means in executive session a substantially modified version of the administration's earlier proposal dealing with the taxation of profits of controlled foreign corporations. This tentative version was prepared by the Treasury Department to reflect some suggestions of committee members and in light of testimony presented to the committee during the hearings on the Treasury's earlier proposal.

The Committee on Ways and Means concluded that this modified proposal deserved further consideration before any action was taken, and, therefore, without prejudice to the tentative draft, concluded that it should be studied during the fall of 1961 and taken up next year. As a result, the Treasury Department made the tentative draft available to the public on July 28, 1961 (release D–186), for the purpose of obtaining comments.

A. IN GENERAL

The President initially recommended that U.S. shareholders be taxed in full each year on their current share of the undistributed profits of their controlled corporations which are organized in developed, or economically advanced, countries. The President's initial recommendations in the case of investments in less developed countries, except in the case of so-called tax haven companies, would have continued taxing U.S. shareholders on earnings of controlled foreign corporations only when dividends were paid. In the case of these "tax haven" companies—generally defined as those receiving more than 20 percent of their gross profit from sources outside the country in which they are created—under the President's initial proposal the U.S. shareholder would be taxed on its share of the current undistributed profits of the foreign corporation.

The modified Treasury proposal, described here, deals only with tax haven problems. It specified certain types of transactions which are to be classified as "tax haven" transactions. Generally, certain specific items of income are so characterized only when they are derived from sources outside the foreign country in which the foreign corporation is organized and from a transaction with a related party. The draft specifies the following different types of income transactions with a related party: Income from purchases, sales, commissions, licensing, dividends, interest, services and insurance. The

income in these cases is classified as giving rise to "tax haven profits" only if the transaction is with the U.S. parent of the foreign corporation or with another party in the same related group. Where these conditions exist these "tax haven profits," where there is the requisite control, are taxed to U.S. shareholders of the foreign corporation even though they are not distributed as dividends. To be so taxed five or fewer U.S. shareholders must directly or indirectly own more than 50 percent of the stock of the foreign corporation. In addition, for any particular U.S. shareholder to be so taxed it must own 10 percent or more of the stock of the foreign corporation.

B. MORE SPECIFICALLY

1. *Undistributed tax haven profits.*—Under the Treasury draft "undistributed tax haven profits" are included, on a pro rata basis, in the gross income of, and currently taxed to, the U.S. shareholders where there is the requisite control. "Tax haven profits" are only the portion of a controlled corporation's profits which arise out of "tax haven" transactions. As a result, part of the profits of a controlled foreign corporation will be taxed currently and a part may not be subject to taxation until dividends are paid. In general, tax haven transactions are those between the foreign corporation and a related party in which the foreign corporation derives its income from the transaction from sources outside the country in which it is organized. Tax haven transactions are limited to the following:

(*a*) *Purchases from related persons.*—Purchase of goods by the controlled foreign corporation from related persons and their sale for use outside the country in which the controlled foreign corporation is organized.

(*b*) *Sales to related persons.*—Purchase of goods by a controlled foreign corporation and their sale to related persons for use outside the country in which the controlled foreign corporation is organized.

(*c*) *Commissions.*—Commissions derived by a controlled foreign corporation from transactions similar to those described in (*a*) and (*b*), above, where it acts as an agent, or broker, instead of on its own account.

(*d*) *Licensing.*—Rentals or royalties received by a controlled foreign corporation for the use of patents, copyrights, trademarks, or other property (whether real or personal) outside the country in which the controlled foreign corporation is organized, if the rights or property were acquired from a related person (and in the case of motion picture films, television tapes and recordings, irrespective of whether they were acquired from a related person).

(*e*) *Holding company income.*—Dividends and interest received by a controlled foreign corporation from the holding of stock or securities in related companies.

(*f*) *Service income.*—Income received by a controlled foreign corporation from furnishing or performing technical, managerial, engineering, or similar services if such services are supplied to, or on behalf of, a related entity, or if such services are substantially managed or directed by officers or employees transferred from a related person for this purpose.

(*g*) *Insurance.*—Income derived by a controlled foreign corporation from insurance or reinsurance of risks situated in the United States, if a related person is the potential beneficiary of such insurance or reinsurance.

The Treasury Department has also indicated that the tax treatment to be accorded income to be derived by a controlled corporation engaged in construction abroad or international transportation is still under study.

The draft further refines categories (*a*) and (*b*), above, to provide that purchases or sales of raw materials or manufactured products are not to be included if the controlled foreign corporation uses these materials or products in further manufacturing which adds at least 20 percent to the value of the finished product. Also, in the case of the sale of property to a related person, there is not to be included those sales in which the property consists of agricultural or horticultural products of the foreign country in which the controlled foreign corporation is organized.

2. *Tests of control.*—Two tests are applied in determining whether a U.S. corporation (or individual) is to be taxed on the undistributed "tax haven" profits of a foreign corporation. First, a group of five or less U.S. shareholders must have a stock interest of more than 50 percent in the foreign corporation before its undistributed profits will be taxed currently to any of the U.S. shareholders. Second, with respect to any single U.S. shareholder these profits are not to be taxed currently to it (even where the first test is met) unless it owns, directly or indirectly, at least 10 percent of the stock of the foreign corporation in question. Thus, if five U.S. shareholders had an interest of more than 50 percent in a foreign corporation, but one of these five has less than a 10-percent interest, then this one shareholder will not be taxed currently on the undistributed earnings of the foreign corporation. The other four, however, if each has an interest of 10 percent or more, will be subject to tax on their pro rata share of such earnings.

As indicated previously, generally the various types of transactions become "tax haven" transactions only if there is a relationship between the foreign corporation in question and the person with which the transaction is carried on. For this purpose a relationship is considered to exist if—

(*a*) the transaction is between an individual, estate, trust, or partnership and a corporation, more than 50 percent of the stock of which is owned directly or indirectly by the individual, estate, trust, or partnership;

(*b*) the transaction is between two corporations, one of which owns directly or indirectly more than 50 percent of the stock of the other corporation; or

(*c*) the transaction is between two corporations, and more than 50 percent of the stock of each is owned directly or indirectly by the same persons.

3. *Other provisions.*—Special rules under the Treasury draft provide that income which has previously been taxed as tax haven income in the year earned will not again be taxed in the year of the actual distribution. Also, where these undistributed profits have been taxed to the U.S. shareholder but the actual distribution has not yet occurred, provision is made for an increase in the basis of the stock

of the shareholder. If this income is subsequently distributed, the basis of the stockholder is again adjusted downward.

Provision is made for the allowance of the foreign tax credit with respect to taxes which were paid by the controlled foreign corporation at the time the undistributed tax haven profits were taxed to the U.S. shareholder. Any foreign taxes subsequently paid with respect to these profits are allowed as a credit under the Treasury draft against U.S. taxes in the year of the actual distribution.

The Treasury proposal would be effective for annual accounting periods of foreign corporations beginning after December 31, 1961, and to taxable years of U.S. shareholders in which these annual accounting periods end.

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