STAFF DATA

NOTES ON BACKGROUND OF EXISTING PROVISIONS OF THE FEDERAL INCOME AND EMPLOYMENT TAX LAWS

PREPARED BY THE STAFFS OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION AND THE TREASURY DEPARTMENT

FOR USE OF THE

COMMITTEE ON WAYS AND MEANS

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LETTER OF SUBMITTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, D.C., August 25, 1960.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. MILLS: In accordance with your request, and as a further contribution to the continuing study of the Internal Revenue Code, there is submitted, herewith, for the information of the committee, a staff document. This document is a brief analysis of the background of existing provisions of the income and employment tax laws.

It is believed that this document will be helpful to the Committee on Ways and Means in evaluating the provisions of existing law.

Respectfully submitted.

COLIN F. STAM, *Chief of Staff.*

NOTES ON BACKGROUND OF EXISTING PROVISIONS OF THE FEDERAL INCOME AND EMPLOYMENT TAX LAWS

As brought out during the hearings in November and December 1959 before the Ways and Means Committee, there are numerous special provisions of current income and employment tax laws which either limit the amount of income subject to tax or provide special rules for the treatment of particular income or deduction items. The purpose of these notes is to set forth briefly, but as accurately as possible from the available records, the original purpose or intent of Congress when enacting provisions that now appear in the income and employment tax laws.

In many cases it is not possible to determine precisely why an item is treated as it is. The committee reports covering the early income tax acts were by no means as detailed as those which have accompanied legislation in more recent years. Frequently, the debates on the floor of Congress also did not disclose why an individual provision was enacted or rejected. However, insofar as possible, these notes try to trace the original reasons for particular provisions that have survived until the present time.

These notes are not intended to serve as a legislative history of the Federal income tax. No effort has been made to trace all the modifications in individual provisions throughout the years they have been effective. Likewise, complete precision in stating the application and limitations of current or past law has not been attempted. While use has been made of the standard legislative histories, textbooks of income tax law, and tax service compilations in preparing this summary, reference should be made to these sources if either a complete record or full detail about a certain tax provision is wanted. The aim of these notes is the modest one of quickly outlining the general objective of, and rationale for, features of the current statute.

The material is arranged in the order in which it appears in the Internal Revenue Code of 1954 as amended to January 1, 1960. Most, but not all, of the substantive sections of Chapter 1 of the code (relating to income taxes) have been covered in these notes. Subchapters C (relating to corporate distributions and adjustments), J (relating to estates and trusts), and K (relating to partners and partnerships), have been omitted because legislation making extensive revisions in these subchapters is pending. Subchapter E (relating to accounting periods), L (relating to insurance companies), and Q (relating to readjustment of tax between years and special limitations) have been omitted either because of limited general interest in these provisions or because they have already received extensive reconsideration in recent years.

In addition to Chapter 1 of Subtitle A of the code, the present summary also covers Subtitle C (employment taxes).

SUBCHAPTER A. DETERMINATION OF TAX LIABILITY—RATE PROVISIONS

PART I.—TAX ON INDIVIDUALS

1. Rates for individuals (*sec. 1*(*a*))

The rate schedule for individuals in its present form dates from 1954, at which time the normal tax of 3 percent and the graduated surtax were combined. This was considered a simplification measure.

2. Rates for heads of households (*sec. 1*(*b*))

This provision was first incorporated in the Revenue Act of 1951 and was designed to give heads of households approximately one-half the benefits of split income previously allowed to married couples. It was reasoned that heads of households who maintained homes for children shared income with them to some extent, but that less sharing was ordinarily involved than would be typical between living spouses. The provision was also designed to avoid a large increase in tax liability to the surviving spouse as a result of death of the marital partner. This latter problem has since been taken care of in part by continuing split income for a limited period (2 years) following death of a husband or wife provided there are surviving children.

3. Split income for husbands and wives (*sec. 2*)

This provision was adopted in 1948. It was designed primarily to equalize the tax treatment of married couples residing in community property and in noncommunity property States. Under earlier law, married couples in community property States in effect could split their income into equal parts for tax purposes, regardless of which spouse earned or received this income. Residents of other States could not.

4. Optional tax if income below $5,000 (*sec. 3*)

This section, which supplies and authorizes use of a table to compute tax liability, was introduced in 1941 as a simplification measure. The original table extended only up to $3,000 of gross income and was designed to be used only after exemptions for dependents had been subtracted. In 1944 the table assumed its present form.

PART II.—TAX ON CORPORATIONS

1. Tax imposed (*sec. 11*)

The 1909 act first levied a tax on corporate net income. This was called an excise tax. The rate was 1 percent. In 1913 the corporate excise tax was reenacted as part of the income tax with only the normal tax rate applying to corporation net income. In 1934 the corporation tax rate was graduated; this system continued through 1938.

In 1939 separate normal and surtax rates were first applied to corporations. The rates of normal tax were lower for corporations with net income of $25,000 or less than for those with larger net income until 1950. Frequent changes, both in the rates and the tax base, occurred during the years the 1939 Code was in effect. The 1954 Code has continued separate normal and surtax rates for corporations but has merged the two bases into a single category of "taxable income."

Part III.—Changes in Rates During a Taxable Year

1. Effect of changes (*sec. 21*)

This section, which provides a general rule for fiscal year taxpayers applicable to periods when rates change, goes back to 1941. Prior to that time the statute contained no rules for fiscal year taxpayers.

Part IV.—Credits Against Tax

1. Tax withheld on wages (*sec. 31*)

This section goes back to 1943 when provisions for withholding of tax from wage and salary payments first became effective. It was necessary to provide that any amounts withheld from an individual's wages would be credited against his income tax liability as finally determined.

2. Tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds (*sec. 32*)

Source collection of tax on these income items goes back to 1918, long antedating the wage withholding system. This section merely provides that any tax withheld may be credited against liability as finally determined.

3. Income taxes paid to foreign countries or U.S. possessions (*sec. 33*)

This credit dates from the Revenue Act of 1918. Prior to that time foreign taxes were allowed as a deduction in computing U.S. tax liability. The purpose of the credit was to provide that a U.S. citizen receiving foreign income would be liable for U.S. taxes on that income only to the extent that the U.S. tax was higher than the foreign tax.

4. Dividends received credit (*sec. 34*)

This credit dates from 1954 and was designed, in combination with the dividend exclusion, to provide some limited relief from the alleged double taxation of corporate income—once to the corporation itself and again to the dividend recipient. The credit was modeled after a similar one adopted by Canada in 1949. Credit for 4 percent of the dividends received is equivalent to exemption of dividends from 4 percentage points of the individual income tax and is analagous to the exemption of dividend income from normal tax which prevailed prior to 1936.

5. Credit for partially tax exempt interest (*sec. 35*)

This credit in present form dates from 1942. Prior to the Public Debt Act of 1941, U.S. securities were issued with varying forms of tax exemption, in the belief that this promoted the sale of these issues at low interest rates. In 1941 it was decided that the interest on future issues of U.S. securities would be fully taxable. Thus this section applies to pre-1941 issues and provides for continuation of the partial tax exemption privilege by means of full inclusion of the interest in taxable income and credit for the normal tax of 3 percent.

6. Credit for retirement income (*sec. 37*)

This credit dates from 1954. It was adopted because social security and certain other retirement incomes were tax exempt, thereby discriminating against recipients of other types of taxable retirement incomes. The credit is at the first bracket rate on retirement income up to $1,200 and is therefore limited to $240. Retirement income on which the credit is based is reduced (except for persons aged 72 or over) dollar for dollar for earnings in excess of certain amounts; as a result, the credit vanishes when earnings exceed $2,100 for persons under 65 and $2,400 for those aged 65 to 72.

SUBCHAPTER B. COMPUTATION OF TAXABLE INCOME

Part I—Definition of Gross Income, Adjusted Gross Income, and Taxable Income

1. Gross income defined (*sec. 61*)

The general idea of this section goes back to 1870 when the statute first spelled out various types of income to be considered for tax purposes. Earlier statutes had merely contained general statements. The definition of gross income for tax purposes has been modified a number of times since 1913 as a result of court decisions and statutory language alterations, but these modifications have not, in general, limited the all inclusive nature of the concept. The definition stood unchanged from 1939 through 1953 but was rewritten in the 1954 Code with no substantive change in scope intended. At that time the 15 listed sources of income were added, essentially as illustrations of the breadth of the gross income concept.

2. Adjusted gross income defined (*sec. 62*)

The concept of adjusted gross income relates to individuals and dates from 1944, when it was first introduced to help determine tax under the tables of supplement T and also as a base for the optional standard deduction. It is gross income less trade and business expenses, including certain business expenses of employees. No significant changes in the definition have been made since 1944.

3. Taxable income defined (*sec. 63*)

The term "taxable income" first appeared in the code revision of 1954 as an effort to clarify the income tax base. It superseded a number of other terms previously employed. Essentially it is gross income less allowable exclusions, deductions, and exemptions.

Part II—Items Specifically Included in Gross Income

1. Alimony and separate maintenance payments (*sec. 71*)

This section, which provides generally that such payments are income to the recipient and deductible to the payor, goes back to 1941. Prior to that time alimony was not taxable to the wife nor deductible to the husband. The stated purpose of the rule was to relieve hardship in certain cases and to overcome variation in State laws concerning the legal obligation to continue alimony.

2. Exclusion ratio for tax-free recovery of capital from an annuity (*sec. 72*)

The present rules date from 1954 and provide for an exclusion ratio to be applied to each payment. Prior to 1934 recovery of capital was allowed first and all subsequent payments were taxed in full as income. In 1934 taxpayers were required to include in taxable income an amount equal to 3 percent of the total cost of the annuity to them from each payment. All receipts after capital had been recovered were includible in income. Thus, before 1954 the tax on an annuity of given size varied before and after capital recovery. Congress thought the tax on annuity proceeds should be certain and not subject to variation and in 1954 adopted a rule which based the exclusion ratio on life expectancy. The 1954 rule gives the same tax over the whole life of an annuity, if tax rates and other factors remain constant. The rule that an annuitant may recover his cost first if it does not exceed the annuity payable for the first 3 years was also added in 1954. It was designed to minimize the necessity for computations by annuitants with small exclusions.

3. Services of a child (*sec. 73*)

This rule, which attributes income of a child to him rather than to his parent, goes back to 1944. Prior to that time local law governed for tax purposes and this varied from State to State. The provision was adopted to get uniformity for Federal income tax purposes.

4. Prizes and awards (*sec. 74*)

This section, which makes prizes and awards, with stated exceptions, an element of gross income, goes back to 1954. It was adopted to overcome uncertainty stemming from certain court decisions which had held that some prizes were income and others, being gifts, were not income.

5. Dealers in tax-exempt securities (*sec. 75*)

This section, which requires dealers in such securities to amortize premium on the securities in their inventory, goes back to 1950. Before that time dealers could deduct artificial losses stemming from large differences between coupon and effective interest rates on bonds they handled. The objective was to close a loophole by eliminating these artificial losses.

6. Commodity credit loans (*sec. 77*)

This section, which gives farmers the option to count crop loans as income, goes back to 1939. Prior to that time farmers could not take income from pledged crops until they were actually sold. This bunched income in certain years and resulted in denial of deduction for production expenses not incurred in the year of sale. The section was adopted to overcome these problems and to recognize that crop loans were equivalent to sales in many instances.

Part III.—Exclusions From Gross Income

1. Proceeds of life insurance at death (*sec. 101*)

This exclusion was first made by statute in 1913. Apparently, however, life insurance proceeds have never been considered part of taxable income in this country. The Civil War income tax statutes used the term "annual income or profits" in describing the tax base. This obviously derived from the language of the British law which also used the terms "annual income or gains." The earlier British statutes allowed limited deductions for life insurance premiums paid when computing taxable income. Such deductions, however, have never been a feature of the U.S. income tax. It should be noted that in excluding death benefits from taxable income, an element of investment income on life insurance policies owned by individuals escapes taxation.

2. Death benefits of an employee up to $5,000 (Sec. 101)

This provision was added in 1951. It was designed to prevent taxation in certain cases where death benefits were received not as the result of an insurance contract but as a gift from an employer and also to equalize the tax treatment of all death benefits, whether or not stemming from an insurance contract.

3. Life insurance proceeds paid at a date later than death (Sec. 101(d))

This rule, which provides for taxation of the interest element in life insurance death benefits paid in installments, goes back to 1954. Prior to that time no tax was assessed on this element of income. It was thought desirable to limit this tax-free interest and hence the present limit of $1,000 per year was written in. Some minimum amount of tax-free interest was thought desirable to encourage taking insurance proceeds in the form of installments rather than as a lump sum.

4. Gifts and inheritances (sec. 102)

These have been excluded from taxable income by statute since 1913. The act of 1894 had taxed all money and property acquired by gift or inheritance. While gifts and inheritances were not an issue in cases under the 1894 tax, the desire in 1913 was apparently to avoid a broad definition of income that might raise constitutional problems.

5. Interest on securities of State and local governments (sec. 103)

This exclusion has been in effect since 1913. An attempt to tax this interest was made under the 1894 statute which was declared unconstitiutional in the *Pollock* case. The reasoning was that a tax on this item invaded the sovereign powers of the States. Congress agreed to this immunity in 1913 and has continued it ever since, despite the fact that the language of the 16th amendment empowers the taxation of all income "from whatever source derived."

6. Workmen's compensation payments and damages for sickness and injury (sec. 104)

This exclusion has been in effect since 1918. Earlier efforts to tax these items under Treasury regulation had been questioned by the courts. The section was written into the statute to remove uncertainty.

7. Pensions and other allowances for sickness and injury while in the Armed Forces (sec. 104)

This exclusion goes back to the World War Veterans Act of 1924. It was written into the Revenue Code by a Senate Amendment in 1942. The desire of Congress at that time apparently was not to tax this item because of possible hardship. The provision was expanded in 1954 to cover the nonmilitary commissioned services, such as the Public Health Service and the Coast and Geodetic Survey, as well as the active military forces.

8. Reimbursement for medical expenses (sec. 105)

This exclusion was added in 1954. The purpose at that time was apparently to equalize the tax treatment of reimbursed medical expenses regardless of whether or not such benefits were payable under an insurance contract. It had been held earlier by Treasury ruling that benefits received pursuant to an insurance contract were not part of taxable income.

9. Payments for permanent loss of body member or function (*sec. 105*)

This exclusion was also added in 1954 and applies to all payments for this purpose whether lump sum or periodic. The purpose of the provision was to cure an earlier discrimination whereby payments of this type had been excludable from taxable income if they were a result of insurance but not otherwise.

10. Sick pay up to $100 per week (*sec. 105*)

This exclusion was also added in 1954. The desire, apparently, was to exempt from tax wage continuation benefits up to a specified maximum, regardless of the source from which paid. The problem again was that certain insurance benefits, regardless of amount, had been excludable from taxable income, whereas wage continuation payments not resulting from a contract of insurance had not been excludable.

11. Employer contributions to accident or health plans (*sec. 106*)

This exclusion was also made specific in 1954. Prior to that time, certain rulings of the Internal Revenue Service had held that, under the 1939 Code, where an employer paid individual insurance premiums for his employees, these constituted taxable income to the employee. If, on the other hand, employees were covered by a group insurance contract, they were not required to include the premiums paid by their employer in their taxable incomes. The desire of Congress apparently was to equalize the tax treatment of this item, regardless of the form of insurance under which employees were covered.

12. Rental value of parsonages (*sec. 107*)

This exclusion has been in effect since 1921 in cases where a house is furnished to a minister as part of his compensation. In 1954 the provision was amended to exclude from taxable income cash rental allowances paid to ministers. This was considered necessary because earlier court cases had differed regarding treatment of this item.

13. Income from discharge of indebtedness (*sec. 108*)

This exclusion had been in force since 1939. It was originally designed to provide relief to corporations in unsound financial condition, whose securities could be retired at less than face value. The treatment provided is adjustment of basis instead of recognition of gain. Under the *Kirby Lumber Co.* case, decided by the Supreme Court in 1931, any redemption of securities by a corporation at less than face value had been held to produce taxable income.

14. Improvements by lessee on lessor's property (*sec. 109*)

This exclusion was added by Senate amendment in 1942. It was designed to overcome the Supreme Court decision in *Helvering* v. *Bruun*, (309 U.S. 461), which held that improvements made by a lessee constituted taxable income to the lessor at the time of forfeiture of the lease. Congress apparently felt that the proper time to tax such improvement was when an increased rental was received for the property by virtue of the improvements, rather than at the time of forfeiture of the lease.

15. Income taxes paid by lessee corporation (*sec. 110*)

This exclusion dates from 1954. It was designed to prevent pyramiding of tax on tax in cases where the lessee had contracted to pay a fixed income to the lessor corporation without reduction for income taxes assessed on the rental payment. This had been a common provision of many long-term leases and under pre-1954 law frequently resulted in income tax liabilities greatly in excess of the initial tax on the rental.

16. Recovery of bad debts, taxes, etc., previously deducted (*sec. 111*)

This exclusion was also adopted in 1942 and was apparently designed to prevent double taxation in cases where no prior tax benefit had been realized as a result of these deductions. The purpose of the exclusion was to preserve the tax value of these deduction items.

17. Certain combat pay of members of the Armed Forces (*sec. 112*)

This exclusion was originally enacted in 1950 during the Korean war and was designed to relieve actual participants in hostilities from some tax liability. It was an adaptation of an earlier wartime provision, enacted in 1942 and allowed to expire January 1, 1949, which exempted from tax all the pay of enlisted personnel on active duty and the first $1,500 of officers pay. The Korean war exclusion was originally scheduled to terminate January 1, 1955, but in 1954 was extended because it was felt this exclusion should continue to be available so long as individuals were subject to the draft for military service.

18. Mustering-out payments (*sec. 113*)

This exclusion was added by Senate amendment in 1943. The theory apparently was that these payments were one time readjustment allowances which ought to be tax free.

19. Sports programs conducted for the Red Cross (*sec. 114*)

This exclusion was added in 1952 by Public Law 465 of the 82d Congress. It was designed to relieve from tax those corporations furnishing sports programs under agreements in writing with the American Red Cross, the proceeds from which programs (minus expenses) would be turned over entirely to the Red Cross. The exclusion is applicable only where covered by agreements entered into after July 8, 1952.

20. Income of States, municipalities, etc., from public utilities or the exercise of any essential governmental function (*sec. 115*)

This exclusion has been generally effective since 1913. The special language in section 115 referring to 1916 (in the case of public utilities operated by persons under contract to States or municipalities) and to 1928 (relating to bridge acquisitions) are a result of the administrative history of this provision which has been generally effective throughout the period of the modern income tax.

21. Dividends up to $50 (*sec. 116*)

This exclusion dates from 1954. It was designed, in combination with the dividends-received credit, to provide limited relief from the alleged double taxation of dividends under prior law. The exclusion was intended to apply only in cases where real double taxation of dividend income was believed to exist.

22. Scholarships and fellowship grants (sec. 117)

This exclusion was also added to the statute in 1954. Earlier, under Treasury rulings, certain grants in cases where no services had been required had been held to be gifts and consequently nontaxable. The provision was designed to correct earlier uncertainties concerning taxability of these items.

23. Contributions to the capital of a corporation (sec. 118)

This exclusion also dates from 1954 and was designed to incorporate in the statute the effect of court decisions on the subject. Such contributions are usually made in expectation of future indirect benefits which, however, are so intangible that they cannot ordinarily be treated as payment for future services. Corporations are required to take a zero basis on any contributions to capital made by nonstockholders.

24. Meals and lodging furnished for the convenience of the employer (sec. 119)

In present form the exclusion dates only from 1954. Prior to that time, there was some uncertainty regarding the inclusion in taxable income of these items. It was held, for example, that where meals and lodging were furnished, even though for the convenience of the employer, they were includable in taxable income of the employee if they were intended to be part of his compensation—for example, if they were taken into account in fixing the compensation to be paid. The purpose of the section was therefore to remove uncertainty in the application of the law.

25. Social security benefits

Although not specifically excluded in the code, social security benefits have, by Treasury ruling, been exempt from tax. This applies to monthly old-age and survivors benefits, which were held analogous to insurance proceeds (IT 3447 C.B. 1941, p. 191), lump-sum benefits to persons aged 65 or more (IT 3194 C.B. 1938, p. 114), old-age assistance payments, and unemployment compensation. Railroad retirement benefits are also excludable from gross income but this exclusion is by statute rather than by ruling. The rulings providing for the exclusions from taxable income of social security benefits were made when these benefits were smaller and income tax exemptions considerably higher than they are at present.

Part IV—Standard Deduction for Individuals

1. Standard deduction (sec. 141)

The standard deductions, a simplification measure, was first made available to all taxpayers in 1944. Prior to 1944, a simplified tax table, incorporating a standard deduction of 6 percent, was available to taxpayers with incomes below $3,000. The 1944 act raised the upper limit of the table to $5,000, increased the standard deduction to 10 percent, and allowed persons with gross incomes of $5,000 or more the option of taking a $500 standard deduction. When the provision allowing married couples to split their income was adopted in 1948, the limit on the standard deduction for married couples filing joint returns and for single persons was increased to $1,000 or 10 percent of adjusted gross income, whichever was lesser; the limit for married persons filing separate returns was retained at $500. The deduction is in lieu of itemized deductions for taxes, interest, contributions, etc.

2. Individuals not eligible for standard deduction (*sec. 142*)

The provision that neither husband nor wife may use the standard deduction unless both goes back to 1944 as does the denial of this deduction to returns covering less than a full 12 months' period. In both cases the purpose was to prevent abuse. Denial of the standard deduction to nonresident aliens, estates or trusts, common trust funds and partnerships also goes back to 1944.

3. Determination of marital status (*sec. 143*)

This section which provides special rules for determining marital status for purposes of eligibility to use the standard deduction was added in 1948. Under the rules a divorced or legally separated person is not married but end of taxable year status is controlling except in case of death when status at date of death is controlling.

4. Election of standard deduction (*sec. 144*)

This section which provides that taxpayers using the stanard deduction must so elect each year also goes back to 1944. Prior to 1951 an election to use this deduction was irrevocable after the time for filing the return had passed. Since then the election may be changed after the return has been filed. This gives greater leeway on an amended return.

Part V—Deductions for Personal Exemptions

1. Personal exemptions for taxpayer and spouse (*sec. 151*(*b*))

In present form this provision dates only from 1954. Prior to that time personal exemptions were technically credits against net income. Some provision for personal and family exemptions has always been a feature of the income tax in this country. The theory of exemptions is based both on administrative convenience (limiting the number of returns) and on the idea that some minimum amount of income (not necessarily related to living costs) should be tax free.

Under the Civil War income taxes, only one exemption was allowed per family. This system was retained through the 1894 Act.

With the 1913 act, exemptions began to be related to family composition. This act allowed $3,000 to a single person and $4,000 to a married couple with no credit for dependents.

Subsequent developments are as shown in the following table:

Personal exemptions and dependency credits in the U.S. income tax

	Single person	Married couple	Each dependent
1917–20	$1,000	$2,000	$200
1920–24	1,000	2,500	400
1925–31	1,500	3,500	400
1932–39	1,000	2,500	400
1940	800	2,000	400
1941	750	1,500	400
1942–43	500	1,200	350

In 1944 the per capita exemption system was introduced, giving, for the first time, dependents equal tax exemption with taxpayers and their spouses. The per capita system was rationalized by the legislating committees as a simplification measure—eliminating earlier uncertainties as to which taxpayers were "heads of families."

2. Additional exemption for persons age 65 or more (*sec. 151*(*c*))

This exemption dates from 1948. It was justified in the committee reports on the grounds that living costs had risen and that older persons typically had more limited opportunities to increase their incomes than did younger persons.

3. Additional exemption for blindness (*sec. 151*(*d*))

This also dates from 1948 when it replaced an earlier special $500 deduction, dating from 1943, allowed for blindness. The exemption was considered preferable to the special deduction because it allowed blind persons to use the standard deduction and because it could be taken into account in withholding, thus making possible lower current tax payments instead of refunds.

4. Exemption for dependents (*sec. 151*(*e*))

In substance this provision dates from 1944 although earlier statutes had allowed dependency credits based on actual financial dependency. The 1944 act abolished the former age and capacity for self support limitations in favor of relationship rules, a gross income test, and a general requirement that the taxpayer must furnish more than one-half the support. The 1954 Code also liberalized the gross income test of dependency in the cases of children under 19 and students.

5. Dependent defined (*sec. 152*)

This section spells out the relationships under which personal exemptions may be claimed for dependents and the support test that must also be met. It goes back to 1944 but was amended in 1953 to include an adopted child.

Part VI—Itemized Deductions for Individuals and Corporations

1. Ordinary and necessary business expenses (*sec. 162*)

These have always been allowed as deductions in arriving at net income. The 1913 act permitted deduction of "necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses." Earlier, the 1909 tax on corporations had used the phrase "all the ordinary and necessary expenses actually paid within the year."

The first Civil War tax statutes were not specific about the deductions allowable in arriving at net income, although net income was clearly intended to be the tax base. However, the act of 1864 provided that—

> when any person rents buildings, lands, or other property or hires labor to carry on land, (sic) or to conduct any other business from which such income is actually derived, or pays interest upon any actual incumbrance thereon, the amount actually paid for such rent, labor, or interest shall be deducted; and also the amount paid out for usual or ordinary repairs.

It is clear from the language of the early statutes that a cash basis of income accounting was contemplated.

2. Interest paid or accrued (*sec. 163*)

This likewise has always been deductible in arriving at net income. The 1913 act used the language "all interest paid within the year by a taxable person on indebtedness." Earlier, the 1894 statute had used substantially similar language.

The disallowance of the interest deduction relating to tax exempt income dates from 1917. The special provision for deduction of interest on installment purchases where the interest charge is not separately stated dates from 1954.

There is no requirement in the statute that interest be either for a business purpose or reasonable in amount in order to be deductible.

3. Taxes (*sec. 164*)

These likewise have always been deductible. The first income tax act in this country, that of 1861 (which never went into effect), provided that—

> in estimating said income, all national, state, or local taxes assessed upon the property from which the income is derived, shall be first deducted.

Other deductions were not specified. Deduction of taxes was considered necessary to arrive at net income, although this term was not used in the statute because of fears it might permit deduction of family or living expenses.

The 1894 act allowed deduction of "all national, State, county, school, and municipal taxes, not including those assessed against local benefits." This language was carried over without change into the 1913 act.

Generally, until 1921 the taxes that could be deducted were stated. Since that time the law has enumerated the exceptions or nondeductible tax items. These now include Federal income and profits taxes, import, excise and stamp taxes, estate, inheritance and gift taxes, as well as those against local benefits which increase the value of property.

4. Losses (*sec. 165*)

Generally, deductions for losses have always been allowed—subject to various qualifications and limitations. The 1913 act used the language—

> losses actually sustained during the year, incurred in trade or arising from fires, storms, or shipwreck and not compensated for by insurance or otherwise.

This language was carried over from the 1894 act.

Losses are classified for income tax purposes into business, casualty, bad debt, and capital losses. The latter two are subject to special provisions and limitations. Carryover provisions for business and for capital losses differ.

Limitations on loss deductibility have an independent history. The limit on gambling losses to the extent of gambling gains dates from 1934. Capital losses have been variously limited and will be discussed in another place. Other loss limitations and carryover provisions will also be noted under the presently governing sections of the code.

5. Bad debts (*sec. 166*)

These also have been consistently deductible. The 1913 act used the language "debts due to the taxpayer actually ascertained to be worthless and charged off within the year"; this was a carryover and expansion of the 1894 language.

Until 1921 only actual bad debts could be deducted. The Revenue Act of that year authorized the anticipation of bad debts by allowing annual additions to a reserve for this purpose. Before 1942 bad debts had to be both ascertained worthless and charged off within the year to be deductible in that year.

Before 1921 the Treasury held that a debt must be entirely worthless to be deductible. The 1921 act authorized the Commissioner to allow deductions for partially worthless debts and this rule has carried down to the present time.

6. Depreciation (sec. 167)

This deduction has been expressly allowed since the 1913 act, which used the language "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business." Earlier, the 1909 Corporation Tax Act had allowed deduction of "a reasonable allowance for depreciation of property."

The 1894 and earlier acts were silent on the subject of depreciation; but Treasury regulations covering the 1894 act forbade deduction of depreciation on personal property and on mines.

Consistently the statute concerning depreciation has been general, not requiring either any certain method of accounting or uniformity in annual deductions, so long as the taxpayer followed a reasonably consistent plan in recovering the original cost or other basis of his property, less salvage value, free of tax. Thus depreciation has an administrative rather than a legislative history in U.S. tax law. An important feature of this administrative history was the shift in 1934 of burden of proof to the taxpayer in questions of the reasonableness of depreciation. In 1953 this rule was modified.

The 1954 Code expanded the preexisting depreciation provision in several respects. For the first time it expressly authorized use of the declining balance and sum of years digit methods of accounting. Earlier authority for these methods had been based on rulings. Committee reports accompanying the 1954 Code said that depreciation should be liberalized because present allowances were "not in accord with economic reality * * * and acted as a barrier to investment." It was felt necessary, however, to confine the liberalized depreciation provisions to new assets having a useful life of 3 years or more in order to "minimize transitional revenue losses and obtain maximum incentive effect."

The 1954 act also introduced a new provision (sec. 167(d)) whereby taxpayers may enter into agreements with the Revenue Service covering the useful lives of property and allowable depreciation rates; such agreements are to be binding in the absence of new factors or considerations. This provision was adopted to remove irritation and controversy in the administration of depreciation.

7. Amortization of emergency facilities (sec. 168)

This provision has a wartime background. It first appeared in the 1918 act to cover facilities constructed or acquired after April 6, 1917, for the production or transport of war materiel. The amount of the deduction was not specified—except that it be reasonable and that tax liabilities in cases where this deduction was taken would be open for recomputation until 3 years after the close of the war. This deduction was continued in the Revenue Act of 1921 for taxable years beginning until March 3, 1924. The amount amortizable was cost less estimated postwar value. In the 1924 act the provision was dropped.

In the second Revenue Act of 1940, new emergency amortization provisions were adopted. These provided for 5-year writeoff by corporations of emergency facilities constructed or acquired under certificates of necessity after July 10, 1940. The provision was intended to remove tax barriers to private investment in facilities required for the war effort.

In the 1942 act, this provision was extended to individuals and partnerships as well as to corporations and was also made retroactive to December 31, 1939. These emergency provisions terminated by Presidential proclamation in September 1945.

They were reenacted with modification in the 1950 act to cover facilities needed for the Korean war. The most important change was that part rather than all of such facilities might be designated for accelerated writeoff.

Emergency amortization was carried over without substantial change into the 1954 act; this contains a clause (sec. 168(i)) that no new certifications will be made after December 31, 1959.

8. Amortization of grain storage facilities (*sec. 169*)

This section was adopted in 1953 on representations to the effect that a critical shortage of facilities for storing grain existed and that such facilities were not ordinarily certifiable for emergency writeoff. The treatment permitted is 5-year amortization limited to facilities completed on or before December 31, 1956.

9. Charitable contributions and gifts (*sec. 170*)

This deduction was first allowed in the 1917 act which said—

> contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of 15 percent of the taxpayers taxable net income as computed without the benefit of this paragraph.

No reason for allowing the deduction was stated, but it may be inferred that the desire of Congress was to encourage such contributions at a time when personal income tax rates were being increased substantially.

The 1921 act broadened the group of organizations to which contributions were deductible by including literary organizations, governments, community funds, and foundations.

Until 1934 corporations were permitted this deduction only if the payments were sufficiently related to their business to be classified as business expenses.

The percentage limitation on charitable deductions has been changed several times.

10. Unlimited charitable deduction (*sec. 170(b)(1)(C)*)

This first appeared by Senate amendment in 1924 and was originally intended to free from tax one who "is habitually contributing to benevolent organizations amounts equaling virtually his entire income." It was amended in 1928 to count taxes as well as contributions toward the 90 percent required to qualify; also in 1954 to qualify if 8 out of 10 preceding years met the 90 percent test.

11. Amortizable bond premium (*sec. 171*)

This deduction was first introduced in 1942 to replace earlier rules under which bond premium had been treated as capital loss and contractual interest as ordinary income. It was felt that the change followed sound accounting practice and also that it denied a capital loss to owners of tax exempt bonds who were not entitled to it. The provision was amended in 1950 to disallow amortization of premium due to conversion features of a bond. In 1954 and 1958 the provision was amended to restrict the amortization premium in the case of callable bonds.

12. Net operating loss deduction (*sec. 172*)

Originally enacted in 1918 for the period until January 1, 1920, this provision allowed business losses to be carried back 1 taxable year and, if necessary, forward to the succeeding taxable year. It was intended to deal with problems of transition from war to peace conditions.

In 1921 the section was reenacted with a 2-year carryforward but no carryback. It was stated in the committee reports that some loss carryover should be a permanent feature of the income tax because of the arbitrariness of the annual accounting period.

With only minor changes, this provision carried on until 1932, at which time the carryforward was reduced to 1 year to conserve revenue. In 1933 it was eliminated altogether by the National Recovery Act.

In 1938 a limited loss carryforward was allowed corporations as one item in the dividends-paid credit. In 1939 the 1921 provision was in essence reenacted, restoring the 2-year carryforward. It was stated at the time that this would aid business and stimulate new enterprises.

In 1942 the provision was again recast—to allow a 2-year carryback as well as the 2-year carryforward. The Finance Committee reasoned this would benefit business in periods of declining profits such as might be experienced at the end of the war.

In 1950 the 2-year carryback was cut to 1 year and the carryforward extended to 5 years. It was stated this would help venture capital generally and both small and new businesses in particular. The 1954 Code enlarged the carryback from 1 year to 2 and Public Law 85–866 made it 3 years beginning January 1, 1958.

Prior to 1954 the loss to be carried over or back had to be reduced by the amount of various items that received special treatment on the taxpayer's return. The intention was to restrict use of the provision to firms that had experienced a real "economic" loss as opposed to firms that had a "statutory" loss due to the specially treated incomes. These special adjustments were substantially eliminated in 1954.

At various times the provision has been described as an averaging device to benefit businesses having fluctuating incomes.

13. Circulation expenditures of a periodical (*sec. 173*)

This section first appeared in 1950 to clarify prior rulings under which expenses to build or maintain circulation, except by purchase, had been generally held deductible but in some cases had been required to be capitalized. The desire was to remove uncertainty in application of the law

14. Research and experimental expenditures (*sec. 174*)

This first appeared in 1954 to clarify prior administrative practice under which such expenditures were deductible to the extent ordinary and necessary for business purposes but had to be capitalized if capital in nature. In this latter case the useful life was frequently uncertain. The desire of Congress was both to remove uncertainty and to stimulate these expenditures.

This section also includes an option to capitalize and amortize such expenditures over 5 years or longer if the taxpayer wishes. This is of value chiefly to small or new business lacking sufficient income to use the current deduction.

15. Soil and water conservation expenditures (*sec. 175*)

This deduction also dates from 1954; it was designed both to clarify prior law and to encourage such expenditures. Before 1954 most outlays of this type had to be capitalized but Tax Court decisions allowed expensing in some cases.

16. Payments to employees of foreign corporations (*sec. 176*)

This provision dates from the Social Security Act Amendments of 1954 which extended coverage to U.S. citizens working abroad for foreign subsidiaries of domestic companies. The deduction allowed covers the employer's contribution to old-age and survivors insurance; and was a logical result of this extended social security coverage.

17. Amortization of trademark and trade name expenditures (*sec. 177*)

This provision dates from 1956 and allows a 5-year writeoff of trademark and trade name expenditures other than consideration paid for a purchased mark or name. Earlier law had required capitalization but the useful life of trademarks was often uncertain. Because large companies could expense more of their legal costs than small companies, this section was also said to help small business.

18. Amortization of improvements by lessee to lessors property (*sec. 178*)

This provision was adopted in 1958 to clarify the rules regarding depreciation of improvements made by a lessee. The section had the effect of tightening the conditions under which such a deduction might be taken.

19. Additional first year depreciation for small business (*sec. 179*)

This deduction was adopted in 1958 and was designed to allow small business faster recovery of capital in order to provide more funds for expansion. The treatment allowed is 20-percent writeoff under a dollar limitation, and regular depreciation for the balance of original cost.

Part VII—Additional Itemized Deductions for Individuals

1. Expenses for production of income (*sec. 212*)

This deduction dates from 1942 and was originally designed to cure uncertainty and to overcome a 1941 Supreme Court decision, *Higgins* v. *Commissioner* (312 U.S. 212), which held that since casual investment was not a business, expenses in connection with such investment were not deductible. Congress thought that since investment income was taxable, expenses relating thereto should logically be deductible.

2. Medical and dental expenses (sec. 213)

This deduction also dates from 1942. It was adopted—

> in consideration of the heavy tax burden that must be borne by individuals during the existing emergency and of the desirability of maintaining the present high level of public health and morale.

The deduction has both a "floor" and a "ceiling." The original floor was 5 percent of net income and the ceiling $2,500 for a joint and $1,250 for a separate return. These ceilings were doubled in 1948.

In 1944 the base of the floor was changed to "adjusted gross" from "net" income. In 1951 the floor was removed for taxpayers and spouses age 65 or more.

In 1954 the 5-percent floor was replaced by the present 3 percent and 1 percent (for medicine and drugs); the maximums were also doubled (to $5,000 and $10,000); expenses of a last illness were allowed even if paid after death.

In 1958 maximum deductions for disabled persons over 65 were increased. In 1960 the 3-percent floor (but not the drug limitation) was removed for expenses paid for a dependent parent aged 65 or over.

3. Expenses for care of certain dependents (sec. 214)

This section dates from 1954. It was adopted because child care expenses were considered somewhat analogous to business expenses. The deduction permitted is actual outlay up to $600, except that in case of working wives the deduction vanishes if joint income of the spouses exceeds $5,100.

4. Alimony payments (sec. 215)

This deduction dates from 1942. Prior to that time all income was taxed to the person earning or receiving this income. Congress reasoned that alimony should be taxable to the wife and deductible to the husband. The change also sought to prevent hardships arising from the sharp increase in tax rates accompanying World War II.

5. Taxes and interest paid to housing cooperatives (sec. 216)

This was adopted in 1942 to place tenant stockholders in a cooperative apartment in the same relative position as homeowners. The deduction allowed is the proportionate share of real estate taxes and mortgage interest paid by the cooperative. The deduction is, in effect, "passed through" the co-op to its tenant shareholders.

Part VIII.—Special Deduction for Corporations Only

1. Partially tax-exempt interest (sec. 242)

This first appeared in 1918 for interest on bonds of the War Finance Corporation, an instrumentality of the U.S. Government. This interest was exempt from normal tax so the provision was originally a credit for purposes of that tax.

2. Dividends received (sec. 243)

This originated in the act of 1909 which excluded from taxable income of a corporation the dividends received from another corporation on which tax had been imposed. The desire was to avoid double taxation.

Under the acts of 1913 and 1916, however, dividends were fully taxable to the recipient corporation. Between 1917 and 1935, dividend income of corporations was fully deductible. When graduated rates on corporate income were introduced in 1935, a restriction was placed on the dividends deduction on the recommendation of the President that a small tax on intercorporate dividends would prevent evasion of the graduated tax. The present limitation of the deduction to 85 percent of dividends dates from 1936 (although the deduction has not always been allowed in its present form).

In 1950 an amendment limited the credit on dividends in kind to the basis of property in the hands of the distributing corporation. This was designed to close a loophole in connection with payment of dividends in the form of appreciated property.

Small business investment companies were given full credit for dividends received in 1958.

3. Dividends received from certain foreign corporations (sec. 245)

This section was enacted in 1951 to extend the dividends-received credit to dividends from foreign corporations engaged in business in the United States but only to the extent of their earnings in the United States. It was intended to overcome discrimination in the earlier rules.

4. Dividends paid on preferred stock of public utilities (sec. 247)

This first appeared in 1942 as a credit against surtax net income. It was reasoned that these dividends were closely analogous to interest on indebtedness. The provisions was amended in 1943 to deny the credit on dividends paid out of earnings accumulated before adoption of the section.

5. Organizational expenditures (sec. 248)

This provision dates from 1954 and provides for optional 5-year amortization of such expenditures. Under earlier law they had to be capitalized and the proper period of amortization was often uncertain. The change was made to conform tax accounting more closely with business accounting practice.

Part IX—Items Not Deductible

1. Personal, living, and family expenses (sec. 262)

The intention not to allow personal expenses as a deduction for income tax purposes goes back to the Civil War acts, although the rule was not explicitly stated until the act of 1913. The act of 1862 did, however, allow the deduction of rent on a dwelling house but not the deduction of other personal expenses. Various attempts were made during the period when the Civil War taxes were in effect to limit the extent of this deduction for dwelling house rent but none was successful. The deduction was justified as placing homeowners and tenants on a more nearly equitable basis.

In the floor discussion on the 1862 act, it was brought out that one reason for not using the term "net income" in the statute was that this might permit the deduction of personal or living expenses and that such was not the intent of Congress.

The 1913 statute used the language—

in computing net income, there shall be allowed as deductions; first the necessary expenses actually paid in carrying on any business not including personal, living or family expenses.

It should be noted, however, that certain personal expenses have always been deductible for income tax purposes; examples are interest on personal indebtedness, interest on the mortgage on a dwelling, taxes imposed by a State on items of personal expenditure and, more recently, extraordinary medical expenses.

2. Capital expenditures (*sec. 263*)

This section, which generally prohibits the expensing of buildings or permanent improvements, likewise goes back to the Civil War income tax acts. The 1864 act contained a clause prohibiting the deduction of—

any amounts paid out for new buildings, permanent improvements, or betterments made to increase the value of any property or estate.

The idea was that such improvements would be subject to allowance for depreciation and that the cost of the property should be spread over its service life.

The 1913 act carried over essentially this same language and also provided that no deduction shall be made—

for any amount of expense for restoring property or making good the exhaustion thereof for which an allowance is or has been made.

Congress has made certain exceptions to the general rule of not allowing expensing of capital expenditures, by permitting some outlays which are essentially of this nature to be expensed. These include outlays for the development of mineral deposits, research and experimental expenditures, soil and water conservation expenditures, certain expenditures for advertising and goodwill, and intangible drilling and development costs in the case of oil and gas wells.

3. Amounts paid in connection with insurance contracts (*sec. 264*)

The general rule that no business may deduct life insurance premiums on an officer or employee when the business itself is the beneficiary of this policy goes back to 1918. It was reasoned at the time that since the business would not be required to take insurance benefits into taxable income, it should not be allowed to deduct the premium payments.

In the development of this provision, there was a difference between the House and the Senate concerning group insurance policies for the benefit of employees. The House bill would have denied all insurance premium deductions, whereas in the Senate bill such deductions were allowed, provided the business itself was not a beneficiary under the policy. This is the rule that was adopted and that has come down to the present time.

The rule denying the deduction of interest on amounts borrowed to carry a single premium life insurance, endowment, or annuity contract was added by the Revenue Act of 1954. It was intended to deal with a specific type of tax avoidance. It was brought out at the time that certain insurance companies had promoted a plan of selling contracts for a nominal cash payment plus a loan to carry the balance of the premium. Interest on this loan became deductible, whereas no benefits from the contract had to be taken into taxable income—at least until a later date.

4. Expenses and interest relating to tax-exempt income (sec. 265)

The denial of the interest deduction on a loan to purchase or carry tax-exempt securities goes back to 1917, but the disallowance of other expenses attributable to tax-exempt income goes back only to 1934. The reasoning was the same in both cases, namely, that since the income earned is not subject to tax, the expenses incurred in connection with this income should not be deductible.

5. Carrying charges on property (sec. 266)

This section, which provides that if a taxpayer elects to capitalize taxes and other carrying charges on property he acquires, he cannot also take such charges as a deduction, goes back to 1942, at which time the election with respect to such charges was first permitted. Prior to this time the election had been allowed with regard to unimproved real estate by Treasury ruling. Congress thought this ruling should be generalized and given statutory sanction.

6. Losses, expenses, and interest in transactions between related taxpayers (sec. 267)

This section, which generally disallows deductions and losses arising from transactions between related taxpayers, as defined in the statute, goes back to 1934. It was designed to deal with numerous problems of tax avoidance that had been brought to the attention of Congress. This enactment originally dealt only with losses between related individuals, including members of a family, corporations controlled by members of a family, fiduciaries of different trusts having the same grantor, and tax-exempt organizations controlled by a family.

The provision covering unpaid expenses and interest goes back to 1937; at this time it was brought out that transactions between individuals and their controlled corporations could often be used to establish artificial tax deductions. A typical case was one in which the majority stockholder in a corporation borrowed the bulk of the corporate net income and paid interest thereon. The debtor kept his books on an accrual basis and took a deduction for interest as it accrued. The creditor, on the other hand, kept his books on a cash basis and thus took no credit for the interest until it was actually received. In such cases payment of interest was frequently delayed or made in years when income was otherwise low.

The provision limits the amount of time that may lapse between a deduction taken by an accrual basis taxpayer and the receipt of income by a related cash basis taxpayer.

The 1954 Code amended this section by providing for an adjustment of gain when property was disposed of to outsiders, after a previous loss on a transaction between related persons had been disallowed. The purpose of this amendment was to produce the same tax result on a sale to an unrelated taxpayer that would have been obtained if the previous transactions between related taxpayers had not taken place.

7. Sale of land with an unharvested crop (*sec. 268*)

The 1951 act which extended capital gain (and ordinary loss) treatment to proceeds from sale of an unharvested crop provided at the same time that no deduction should be allowed for expenses attributable to the production of the crop. These expenses are added to the basis of the property for purposes of computing the capital gain; thus reducing the amount of gain realized from the sale. In other words, the tax value of the deduction is limited to the tax of 25 percent or less paid on the capital gain.

8. Acquisitions made to evade or avoid income tax (*sec. 269*)

This section was enacted in 1943 to deal with a number of avoidance problems. It was made retroactive in effect to 1940. A typical practice, with which the section was designed to cope, was of corporations having large excess profits purchasing other corporations with losses, deficits, or unused excess profits tax credits for the purpose of reducing the combined tax liability after consolidation.

The section also provides authority to disallow deductions, credits, or allowances in part where there is an acquisition for several reasons, not all of which are connected with tax avoidance. The burden of proof rules applicable to this section where modified in 1954 in order to make enforcement somewhat easier.

9. Limitation on deductions allowable to individuals (*sec. 270*)

This section which dates from 1943 deals with so-called "hobby losses" of individuals. The section provides that where expenses attributable to a trade or business exceed the gross income from such business by $50,000 or more per year for a period of 5 consecutive years, the tax shall be recomputed and the business expense deductions allowed only to the extent of producing one $50,000 loss.

The problem with which the section is designed to cope is the operation of farms and other hobby ventures at a loss, using the loss to offset income from other sources. It was reasoned that businesses showing such large losses would not ordinarily be continued unless the taxpayer had a substantial amount of other income, and also that the business expenses in many cases represented disguised personal, family, or living expenses, particularly when the business was a farm.

10. Debts owed by political parties (*sec. 271*)

This section, which disallows a deduction for bad debts represented by loans to political parties, goes back to 1952. At that time it was explained that since contributions to political parties were not deductible, some individuals had been disguising such contributions as loans; subsequently they wrote off the loan as a bad debt, thus in effect acquiring a forbidden tax deduction.

The purpose of the section is to cope with such practices and also with prior rulings of the Treasury whereby these bad debt deductions had been allowed.

11. Disposal of coal (*sec. 272*)

This section, which is similar in effect to the provision concerning sale of land with an unharvested crop (sec. 268), was added by the Revenue Act of 1954. The 1951 act extended capital gain (and ordinary loss) treatment to receipts from coal royalties. The 1954 act specified that no deduction is to be allowed for certain expenses in connection with the receipts from such royalties. These expenses are to be treated as an adjustment to the basis and an offset against capital gain.

12. Holders of life or terminable interest (sec. 273)

This section, which provides that income received from a life estate or other terminable interest acquired by gift, bequest, or inheritance shall not be diminished by any deduction due to the passage of time goes back to 1921. Prior to that time, certain individuals had capitalized these interests and claimed a deduction analogous to depreciation on this capital value. Certain State statutes and court decisions gave color to these claims so the section was enacted to make certain they would not be allowable.

SUBCHAPTER D. DEFERRED COMPENSATION, ETC.

PART I—PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

1. Definition of a qualified pension, profit sharing, or stock bonus plan (sec. 401)

This section, which provides that such employee trusts as qualify for tax exemption must implement plans that cover employees generally and are nondiscriminatory, dates from 1942. Prior to that time, although pension and other trusts had been exempt from tax, no qualification of the plans had been necessary. As a result, the provisions of earlier law were somewhat abused by discriminatory plans which covered only small percentages of all employees or which favored highly paid employees against those who were paid less. The purpose of the provision was to encourage the spread of broad based pension and other programs for the exclusive benefit of employees.

2. General rule for taxing the beneficiary of an employee trust (sec. 402)

This section, which provides that employees shall be taxed at the time pension or other benefits are received, dates from 1921. The purpose was to encourage employers to make provision for their employees. As originally enacted, this provision covered only stock-bonus and profit-sharing plans and not retirement programs.

3. Taxation of employee annuities and lump-sum payments under qualified pension plans (secs. 402 and 403)

Since 1954 employee annuities have been taxed under the life expectancy method. (See sec. 72.)

In 1942 capital gains treatment was accorded to lump sums distributed by qualified pension trusts to employees because of separation from service. In 1954 capital gains treatment was extended to similar lump-sum distributions made under qualified nontrusteed plans. In addition, for both trusteed and nontrusteed plans, capital gains treatment was extended to lump-sum distributions made to beneficiaries of employees who die after retirement. The desire of Congress in the 1954 legislation was to equalize the tax treatment for both trusteed and nontrusteed plans and to accord the same treatment to lump-sum distributions made at separation from service and death.

The rule that any unrealized appreciation on securities of the employing corporation, which are distributed to the employee as part of a lump-sum settlement, shall not be taxed until sold was added by the Revenue Act of 1951. It was said that the prior rule had the effects of bunching for taxation in 1 year the employer's contributions made over a number of years, and also of reducing undesirably the retirement income of employees whose pension funds were invested in stock of the employing corporation.

4. Deductions for employer contributions to qualified pension plans (sec. 404)

Since 1942 employer deductions to employee pension plans have generally been limited to amounts actuarially needed to finance stated benefits. The limitation on contributions to stock-bonus and profit-sharing plans (at 15 percent of the compensation otherwise paid) also dates from 1942. The purpose of these limitations was to prevent abuses which had crept in under the earlier law. The provisions dealing with pension and similar programs were brought together in one place in the Internal Revenue Code of 1954.

Part II—Miscellaneous Provisions

1. Employers restricted stock options (sec. 421)

This section, which imposes no tax at the time that a "restricted" option is granted or exercised, and provides for capital gains treatment when the stock is sold, dates from 1950. The stated purpose of the provision was to assist corporations in attracting new management by enabling them to offer incentive compensation. Under earlier law the difference between the option price and the fair market value of the stock had been taxable to the employee as compensation at the time the option was exercised. Technical amendments were made to this provision in 1954 and 1958.

SUBCHAPTER F. ORGANIZATIONS EXEMPT FROM INCOME TAX

Part I—General Rule

1. List of organizations exempt from tax (sec. 501)

The general idea that certain organizations, not carried on primarily for profit, shall be exempt from income tax goes back to the original Revenue Act of 1913. The original exemption list included labor, agricultural, and horticultural organizations; mutual savings banks not having capital stock; fraternal beneficiary societies; building and loan associations; cemetery companies; and organizations for religious, charitable, scientific or educational purposes—as well as business leagues, chambers of commerce, boards of trade, and civic leagues. The thought was that such organizations were engaged exclusively in promoting general social welfare and therefore should not be taxed.

The 1936 act added to the exempt list water users associations operating Federal reclamation projects, and religious or apostolic associations having a common treasury. Water users associations had not generally been in existence in 1913, while certain religious organizations had been taxed as corporations because their members were prevented from owning property in an individual capacity. Mutual savings banks and building and loan associations were deleted from the tax exempt list by the Revenue Act of 1951.

2. Denial of tax-exempt status to feeder organizations (*sec. 502*)

This provision, denying tax exemption to a business, even though all its net income goes to a charitable or other exempt organization, dates from 1950. Under prior court decisions and rulings certain profit-making business organizations, although not carrying on a charitable or other social welfare purpose, had succeeded in obtaining tax exemption because all their net income went to an exempt organization. It was thought that this situation made for unfair competition between taxable and tax-exempt business organizations, and was an unwarranted extension of the tax exemption privilege. The 1950 act also imposed for the first time a tax on the unrelated business income of exempt organizations.

3. Denial of tax exemption because of prohibited transactions (*sec. 503*)

This section, which establishes certain operating standards for exempt organizations, also dates from 1950. The original purpose was to cope with certain abuses which had been noted in dealings between exempt organizations and their creators or substantial donors thereto. The general objective was to prevent tax avoidance by individuals from arising as a result of dealings with exempt organizations. Trusts constituting part of an exempt pension, bonus, or profit sharing plan were brought under the scope of this section by the Internal Revenue Code of 1954.

4. Denial of exemptions in case of unreasonable accumulation of funds or use for some nonexempt purpose (*sec. 504*)

This provision also dates from 1950 and was designed to deal with abuses that had been noted prior to that time, especially the exemption from tax of income not expended for exempt purposes within a reasonable period of time. In the development of the 1950 act, the House would have imposed a special tax on unreasonable accumulations by tax-exempt organizations to which section 503 is applicable. Specific rules were set forth to measure unreasonable accumulations. Senate objections to this proposal as too rigid resulted in essentially the present language being adopted as a compromise.

Part II—Taxation of Business Income of Certain Exempt Organizations

1. Imposition of tax on the unrelated business income of exempt organizations (*sec. 511*)

This provision, which levies the corporate rate on unrelated business income (a defined term), also dates from 1950. Its primary purpose was to equalize the competitive position of different business organizations. The tax was levied on labor, agricultural, or horticultural organizations as well as on religious, charitable, or educational organizations (except churches), and business leagues. The tax did not apply to social clubs, fraternal societies, nor the exempt business organizations—primarily financial organizations—such as mutual thrift institutions, credit unions, and mutual insurance companies.

The business activities of State colleges and universities were made taxable in 1951. Exempt pension trusts, etc. were brought within the scope of the section by the Internal Revenue Code of 1954.

2. Definition of taxable unrelated business income of an exempt organization (*sec. 512*)

This section, which defines the tax base for exempt organizations with unrelated business income, also dates from 1950. The definition of taxable income worked out in this section is a special one that does not correspond closely with taxable income as elsewhere defined. Generally speaking, all property income (except certain rents) received by the exempt organization is excluded from the base of unrelated business income that is subjected to tax. The definition of an unrelated trade or business found in section 513 of the present code is also a carryover without substantial change from the 1950 act. Essentially, an unrelated business activity is an active operation, as contrasted with a passive operation of obtaining income from property, which is not substantially related to the purpose for which the organization has been granted exemption.

3. Business leases (*sec. 514*)

This section, which is an attempt to cope with the so-called "leaseback" problem, also dates from 1950. Prior to that time a number of tax-exempt organizations had been purchasing business property, frequently with borrowed funds, and then leasing it back to the business selling the property. This amounted to trading on the tax exemption privilege. In general terms, the solution of section 514 is to treat as unrelated income any rents proportionate to the financing of property with borrowed funds—but to continue the exemption with regard to rents insofar as the property represents investments of the exempt organization. The desire behind this provision was to prevent abuse of the tax exemption privilege, and also to equalize competition in bidding for property between exempt and taxable organizations.

4. Extension of foreign tax credit to exempt organizations (*sec. 515*)

This technical provision was also adopted in 1950. It extends the foreign tax credit to any unrelated business income of an exempt organization which is subject to tax. The purpose was to prevent a double tax on any unrelated business income of an exempt organization that might derive from foreign sources and hence be subject to tax by a foreign government.

Part III—Farmers Cooperatives

1. Exemption of certain farmers' cooperatives (*sec. 521*)

The exemption of farm marketing cooperatives dates from the Revenue Act of 1916, which exempted cooperatives that were selling agents for the individual farmer and returned all proceeds to the farmers after selling expenses. In 1921 the exemption was extended on the same terms to purchasing co-ops, and in 1926 certain language was added to make it clear that the liberal construction placed on the section by the Treasury Department had been sanctioned by Congress. Minor amendments were made in 1932 and 1934.

2. Tax on farmers' cooperatives (sec. 522)

This section, which taxes the retained earnings of exempt cooperatives to the extent that such earnings are not paid or allocated to patrons or stockholders as dividends, dates from 1951. The section is intended to tax currently all income of cooperatives at either the cooperative or patron/stockholder level.

Part IV—Shipowners Protection and Indemnities Associations

1. Exemption of shipowners' protection and indemnity associations (sec. 526)

Certain receipts of these organizations were exempted from tax in 1921. Before 1921 certain funds of these shipowners' associations had been taxed as income by Treasury ruling. The 1921 law provided that only receipts from interest, dividends, and rents would be taxable. The purpose of the amendment was to make clear that these organizations, as essentially mutual insurance companies, had no taxable income with respect to their purely insurance receipts.

SUBCHAPTER G. CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS

Part I—Corporations Improperly Accumulating Surplus

1. Penalty tax on accumulated earnings (sec. 531)

The fact that retention of earnings in a corporation might be a device for avoiding individual income taxes was recognized as a problem from the first income tax act. The act of 1913 contained a provision whereby, if a corporation was accumulating surplus so as to permit shareholders to avoid income tax, this surplus could be allocated to the individual shareholders and taxed as personal income. This provision was quite uncertain in application and also left a good deal to the discretion of the Treasury Department.

In 1917 a special surtax of 10 percent was imposed on any corporation net income remaining undistributed 6 months after the end of the taxable year—with the proviso that this additional tax would not apply to any undistributed net income actually invested or employed in the business, or retained because of reasonable requirements of the business. At the same time, the law maintained the earlier system of attributing the retained corporation income to the shareholders where the corporation was fraudulently availed of to avoid surtax.

In 1918 the earlier rule, which provided for allocation of corporate surplus to shareholders, was restored. Another significant change was that the Treasury was no longer required to prove fraud in applying this provision.

In 1921 the penalty tax was again put back on the corporation, partly because the constitutionally of partnership treatment was considered questionable as a result of the Supreme Court decision in *Eisner* v. *Macomber* (1920). The penalty tax was 25 percent; but the law also contained a provision that, if all stockholders agreed, partnership treatment might be applied in lieu of this penalty tax.

In 1924 the penalty tax on corporate surplus was raised to 50 percent in recognition of the higher rates then applicable to individual income. In 1938 this partnership approach was changed to provide that income could be attributed to shareholders to the extent that any (or all) consented to such treatment.

2. Corporations subject to penalty tax on surplus accumulation (*sec. 532*)

This section, which exempts from the penalty tax personal holding companies, whether foreign or domestic, dates from 1934. At that time the surtax on personal holding companies was imposed; as the rate of this tax was higher than the rate on corporations improperly accumulating surplus, it was felt to be a more appropriate penalty.

3. Evidence of purpose to avoid income tax (*sec. 533*)

This section, being coordinate with the penalty tax imposed by section 531, has substantially the same history. The language of the 1913 act stated that accumulation of gains and profits beyond the reasonable needs of the business should be presumptive evidence of a fraudulent intent to escape the income tax. The 1918 act removed the necessity of proving fraudulent intent, as already noted.

4. Burden of proof in imposition of the tax on unreasonable surplus accumulation (*sec. 534*)

This section, which makes it necessary for the Government to prove unreasonable surplus accumulation for purposes of the penalty tax, dates from the code revision in 1954. Prior to that time, the burden of proof had been on the taxpayer. This change in the burden of proof was considered necessary because of the relatively poor record of the Government in litigating cases and because of a belief that the tax had been used chiefly as a threat; these factors indicated to the Congress that attempts to apply the penalty tax had not been adequately screened or analyzed.

It was also felt that the burden of proof rule worked a hardship on small corporations, which sometimes found it cheaper to pay the penalty tax than to litigate their cases. Burden of proof is shifted to the Government only in cases where the taxpayer files a statement setting forth the reasons for the surplus accumulation and its relation to the needs of his business. If no such statement is filed, the burden of proof remains on the taxpayer, as under prior law.

5. Accumulated taxable income (*sec. 535*)

This section, which defines the base of the penalty tax on surplus accumulation, has been gradually evolving since 1924. Prior to that time the base for this tax was the same as for the general corporation income tax. The 1924 act—which provided partnership treatment—made sure that dividends received by a holding company from another corporation would be counted in the holding company income and that interest on obligations of the U.S. Government, issued after September 1, 1917, would be similarly counted.

The 1934 act made clear for the first time that the penalty tax would be imposed only on the undistributed net income of a corporation improperly accumulating surplus. The 1936 act defined the base of the penalty tax more specifically, by detailing the deductions that might be taken to arrive at the tax base. Further refinements in this definition were made in 1938, 1939, and 1942; additional definitional changes were made in 1951. The most important of these was the exclusion both of capital gains and the tax thereon from the penalty tax base.

The Internal Revenue Code of 1954 provided that the tax should apply only to the part of the earnings considered to be unreasonably accumulated, and also provided that a minimum accumulation of $60,000 a year would not be subject to penalty tax. The minimum credit was raised to $100,000 in 1958.

Part II—Personal Holding Companies

1. *Tax on personal holding companies (sec. 541)*

This section goes back to 1934, at which time the personal holding company was distinguished from other corporations improperly accumulating surplus. It was felt at the time that the penalty tax on surplus accumulation did not cope with all the avenues of tax avoidance; also that improper accumulation of surplus was difficult to prove in individual instances. This was in spite of the fact that the burden of proof was on the taxpayer rather than the Government. Congress sought to devise a tax which would be levied automatically against corporations falling within the definition of personal holding companies, without the necessity of proving a purpose of avoiding income tax on the part of the shareholders.

As first imposed, this tax had two brackets with rates of 30 and 40 percent. The rates were increased and the provisions of this tax generally revised in 1937 because there were still opportunities for tax avoidance by individuals having very large incomes, particularly through multiple holding companies. The present rates of 75 and 85 percent date from 1942.

Under the 1939 Code, the personal holding company tax was separate, for administration and collection purposes, from the income tax. Under the 1954 Code, it has been entirely integrated with the income tax. The high rates of this tax are designed to discourage the formation of personal holding companies rather than to produce revenue.

2. *Definition of a personal holding company (sec. 542)*

This section, which defines the corporations to which the penalty tax applies, likewise goes back to 1934. The original definition of a personal holding company in the 1934 act was basically similar to the present definition, in that 50 percent or more of the value of outstanding stock had to be owned by not more than 5 individuals and 80 percent or more of the gross income had to be dividends, interest, or other investment income.

The rules in this section dealing with groups of corporations that file consolidated returns are now somewhat different than they were under the 1939 Code. Then, the income test was applicable separately to each corporate member of an affiliated group except for certain railroad corporations. Now, with several exceptions, the consolidated income of a group determines the application of the tax.

The list of exceptions to the definition of a personal holding company, which now numbers nine categories of financial institutions, has likewise gradually evolved since 1934.

3. *Personal holding company income (sec. 543)*

This section—defining the types of income which, if received in sufficient volume, will make a corporation liable for the penalty tax—has also evolved gradually since 1934. In general, the present definition encompasses nine forms of income which count in determining whether 80 percent or more of the total income is received from the specified sources. Definitions of this type are necessary for proper administration of the penalty tax provisions and illustrate the growing tendency for the Revenue Code to contain more and more specific rules for determining precisely the application of a given tax.

4. Rules for determining stockownership (*sec. 544*)

These detailed rules are also necessary because of the basic form of the penalty tax on personal holding companies; the tax applies only if there is a certain concentration of stockownership. These rules also go back to 1934 but have grown more specific in the period since they were first adopted. A principal feature of the rules is a "constructive stockownership" provision attributing stock held by a corporation, partnership, estate, or trust to the individual shareholders, partners, or beneficiaries. Without this rule the ownership test of a personal holding company could easily be circumvented.

5. Undistributed personal holding company income (*sec. 545*)

This section, which defines the base of the penalty tax on personal holding companies, also goes back to 1934. At that time the base of the tax was net income plus dividends received less: income taxes, 20 percent of net income less income taxes, dividends paid, amounts used or set aside for the retirement of indebtedness incurred before imposition of the tax, and charitable gifts and capital losses not deductible for income tax purposes. The 20-percent deduction was deleted in 1937. In 1938 personal holding companies were allowed a limited dividend carryover when computing the dividends paid credit. This had been permitted for corporations generally in the 1936 act but denied to personal holding companies. Various amendments have been made several times since then, such as those relating to the treatment of operating losses and capital gains.

This is another example of a special definition of taxable net income for a particular purpose. In the 1954 Code several technical changes were made to cast this section into its present form. Generally, these amendments were designed to deal with specific avoidance situations that had arisen under the prior language. Other technical amendments to this section were made in 1958.

6. Deduction for deficiency dividends (*sec 547*)

This section, which in general terms allows a corporation to eliminate a prior personal holding company tax by making a special distribution of dividends, goes back to 1938. Under prior law a holding company had no opportunity to offset a tax deficiency asserted by the Internal Revenue Service or by the courts by means of a special dividend distribution. The original 1938 provision allowed 60 days after final determination of a tax deficiency in which so-called "deficiency dividends" might be paid. Only 65 percent of the first $2,000 of deficiency dividends and 75 percent of the remainder could be credited against the deficiency. None of the dividends could be offset against interest and additions to tax. Minor changes were made in 1941 and 1942. The code revision of 1954 permitted all of the deficiency dividends to be offset against a tax deficiency.

The purpose of these latter changes was to encourage the payment of such deficiency dividends. This purpose was regarded as consistent with the underlying objective of the penalty tax, which is to encourage the distribution of personal holding company income to the stockholders, instead of its retention within the corporation.

Part III—Foreign Personal Holding Companies

1. Foreign personal holding company income taxed to U.S. shareholders (sec. 551)

This provision, which attributes the undistributed income of a foreign personal holding company as dividends to the U.S. shareholders, goes back to 1937. Prior to that time considerable evidence had accumulated to the effect that foreign personal holding companies were being used by U.S. citizens as a tax avoidance device. The method chosen—of attributing the holding company income to the shareholders—was picked because it was not feasible to assert tax against a foreign corporation; this method was modeled after a previous Canadian enactment.

In applying this treatment, it was necessary to make several special rules and definitions but these have all come down essentially unchanged since the original enactment. The section should be regarded as a loophole closing measure.

2. Definition of foreign personal holding company (sec. 552)

The type of foreign company to which the partnership treatment described above will be applied was originally defined in 1937 as a company in which majority ownership lay in the hands of five or fewer U.S. stockholders and which derived 60 percent or more (in some cases 50 percent or more) of its income from specified sources. This definition has come down essentially unchanged.

3. Definition of foreign personal holding company income (sec. 553)

This section requires that the gross income of a foreign personal holding company shall be computed as if it were a domestic corporation. In other words all income, irrespective of whether it is derived from sources within or without the United States, is counted. This definition goes back to 1937 and is necessary to avoid escape from the tax which generally would not apply if only income from sources within the United States were counted.

4. Stock ownership of foreign personal holding companies (sec. 554)

The rules for determination of stockownership rules have always followed those used for domestic personal holding companies.

5. Gross income of foreign personal holding companies (sec. 555)

This definition, which is parallel to that for domestic personal holding companies, also goes back to 1937. It has come down essentially unchanged since that time. Where two or more layers of foreign personal holding companies are involved, income is attributed up the scale even if not distributed. The rules dealing with proration of earnings in such cases, where the holding company has owned stock in other holding companies for less than a full year, are detailed. Other rules provide that all interest shall be counted regardless of whether such interest would be treated as rent under the provisions applicable to domestic corporations; and also all royalty income shall be included for purposes of the gross income test. This broad definition is for the purpose of making it more difficult for a foreign corporation to escape classification as a personal holding company.

6. Undistributed foreign personal holding company income (*sec. 556*)

This section, which defines the amount of income which will be attributed to shareholders, even though not paid to them, also goes back to 1937. In form, the section lists in detail those deductions which may be taken to arrive at undistributed income. In general these deductions parallel those allowable for a domestic personal holding company. Minor amendments to this section were made in 1954.

Part IV.—Deduction for Dividend Paid

1. Deduction for dividends paid (*sec. 561*)

This section defines the dividends that may be deducted in determining the retained income of a foreign or domestic personal holding company (or any corporation for purposes of the accumulated earnings tax). Dividends deductible are those actually paid, the so-called "consent dividends," and, in the case of domestic personal holding companies, a limited dividend carryover. The dividend carryover dates from 1938. Dividends paid are the same as for corporations generally, for purposes of the accumulated earnings tax, as defined in the 1936 act. The object is to recognize that dividend payments may take forms other than cash distributions.

This general principle is followed by precise rules, set forth in section 562, as to just which distributions by corporations qualify as dividends for the present purpose. Rules again are parallel to those in effect for domestic personal holding companies and to a certain extent for corporations generally.

2. Rules applicable in determining dividends eligible for dividends paid deduction (*sec. 562*)

"Dividends" for purposes of the dividend paid deduction has the same meaning as for general corporate purposes as described in section 316, that is, any distribution of earnings and profits. The coordination of the definition of dividends paid dates back to 1936.

In addition, for domestic personal holding companies, a dividend means any distribution to the extent of its undistributed personal holding company income. This definition was enacted by the 1942 act, retroactive to the effective date of the 1939 Code, to take account of the fact that "earnings and profits" can be lesser than "undistributed personal holding company income."

3. Rules relating to dividends paid after close of taxable year (*sec. 563*)

This section allows dividends paid within a limited period following the close of a taxable year to count for deduction purposes—for both the penalty tax on accumulated earnings and the personal holding company tax. The provision dates from 1938. The section recognizes that the purpose of both these taxes is to encourage the distribution of dividends. Section 564 provides rules for computation of the limited dividend carryover that is allowed in determining undistributed income of a foreign personal holding company.

4. Dividend carryover (*sec. 564*)

This section provides that the deduction for dividends paid in any year for domestic personal holding companies shall include a carryover of the excess of dividends paid over taxable income from the 2 preceding taxable years. The provision dates from 1938.

5. Consent dividends (sec. 565)

So-called "consent dividends" are a feature both of the accumulated earnings tax and the tax on personal holding companies, both foreign and domestic. In brief, consent dividends are dividends not actually paid but which, under written agreement with the Internal Revenue Service, will nevertheless be attributed to stockholders and included in their personal incomes for tax purposes. Consent stock is generally common stock on which such agreements as to dividend treatment have been filed. The consent dividend provisions, which go back to 1938, have as their purpose alleviating the situation of corporations that might be liable for penalty taxes but which are unable, because of requirements of the business, to pay cash dividends. The effect is the same as though the dividend had been paid in cash and the amount immediately reinvested in the corporation.

SUBCHAPTER H. BANKING INSTITUTIONS

Part I—Rules of General Application to Banking Institutions

The 1954 Code collected all the special provisions and rules applicable to banking institutions in one place. Previously they had been scattered through various sections of the code.

1. Bad debt and loss deduction on securities held by banks (sec. 582)

Subsection (a), which provides that bad debts collateralled by securities shall be treated as business losses rather than as capital losses, goes back to 1938. The purpose was to avoid imposing a capital loss limitation on banks for losses resulting from transactions undertaken in the ordinary course of business, namely, the making of loans.

Subsection (b), which provides that worthless stock in an affiliated bank shall be an ordinary loss, also goes back to 1938. Prior to that time all losses on worthless securities were ordinary losses and could be deducted from taxable income without limit. In 1938 worthless securities were generally reclassified as capital losses subject to a limitation. Stock in affiliated banks was made an exception to this general rule and hence removed from this limitation on the theory that banks were required by regulatory agencies to take such deductions in full.

Subsection (c), which provides that any losses on bonds owned by a bank shall be ordinary rather than capital losses, goes back to 1932—at which time a capital loss limitation was first imposed. The desire was to exempt banks from this limitation on the theory that bond investments were undertaken in the normal course of the banking business. The other side of this proposition, namely, that any gain on bonds should be ordinary income, was not followed up either at this time or subsequently.

2. Deduction of dividends paid on certain preferred stock (sec. 583)

This section, which provides in effect that any dividends on preferred stock owned by the Reconstruction Finance Corporation shall be deductible for income tax purposes, goes back to 1935. At that time the RFC was either making loans to banks in difficulty or was supplying additional capital by taking preferred stock. If the transaction took the form of a loan, the interest was deductible; if capital support was secured by an issue of preferred stock, the dividends on this stock were not deductible. It was felt at the time that the RFC should be free to support shaky banks by either method without income tax consequences. The provision is applicable only to taxable years beginning after December 31, 1934.

3. Common trust funds (*sec. 584*)

This section provides generally that common trust funds operated by banks, for the collective investment of funds placed by different individuals with the bank as trustee, shall be exempt from tax as entities but that all income shall be allocated to the individual trusts participating in the common fund. The section goes back to 1936; it was designed at the time to overcome certain court decisions under which there was danger that common trust funds might be taxed as corporations. It was felt at the time that common trust funds were used primarily by small investors and should be taxed at the level of the individual trust rather than in the aggregate.

Part II—Mutual Savings Banks, Etc.

1. Deduction for dividends paid on deposits by mutual thrift institutions (*sec. 591*)

This section, which provides that dividends paid or credited to depositors in these institutions shall be a deduction in determining the taxable income of the institution itself, goes back to 1951; at this time, tax on these institutions was first imposed. Prior to that time they had been tax exempt.

They were subjected to tax on the theory that they were in competition with commercial banks and that some tax should be paid either by the institution itself or by the individual depositor.

Since it was felt impractical to require individual depositors to take into their personal incomes amounts retained by the mutual thrift institutions, and hence not available to these depositors, tax on the retained earnings was laid on the institution. The intention, however, was to impose only a single tax, on either the institution or its depositors, and not a double tax as in the case of an ordinary corporation having shareholders.

2. Additions to reserve for bad debts (*sec. 593*)

This section, which permits mutual thrift institutions to deduct additions to a reserve for bad debts until its combined reserve and surplus equal 12 percent of total deposits, also goes back to 1951. The limit of 12 percent on tax free reserve accumulation was fixed in conference between the House and Senate, and evidently represented a compromise between conflicting points of view.

3. Alternative tax for mutual savings banks conducting life insurance business (*sec. 594*)

This section also goes back to 1951. It was added in recognition of the fact that in certain States mutual savings banks regularly carried on a life insurance business. The section simply provides that where such a business is conducted, the income of the agency shall be split into two parts; the part attributable to life insurance business shall be taxed like other life insurance companies, while the part attributable to ordinary savings bank business shall be taxed like other mutual savings banks.

Part III—Bank Affiliates

7. Special deduction for bank affiliates (*sec. 601*)

This section goes back to 1936 and applies only to bank holding company affiliates. Under the supervision of the Federal Reserve Board, these affiliates are required to maintain a certain ratio between bank stocks and other marketable investments in their portfolios. The deduction allowed is either for purposes of the accumulated earnings tax or the personal holding company tax for the amount of earnings or profits used to acquire "other marketable investments" as required by law. When first enacted this section was intended to be a relief provision.

SUBCHAPTER I. NATURAL RESOURCES

Part I—Deductions

1. Allowance of deduction for depletion (*sec. 611*(*a*))

The Revenue Act of 1913 was the first to permit a deduction for depletion. The deduction was limited to 5 percent of the gross value of the annual output, which in many cases did not return the capital invested. In the 1916 Revenue Act Congress authorized a "reasonable allowance" for depletion (specifically mentioning oil and gas wells, as well as mines) until cost, including March 1, 1913, value, had been recovered tax free.

The 1918 act added depletion based on cost for other natural deposits and timber. The provision in the 1918 act for a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, is essentially the language in the present code.

In the 1932 act a change in computing depletion on cost was made; this required an adjustment to recoverable units, but not the basis for depletion, where a new estimate is determined in the light of subsequent events. The Revenue Act of 1934 was the first to provide specifically that percentage depletion was allowable under this section, rather than under the section setting forth the percentage depletion allowances (presently sec. 613).

The 1954 Code enlarged the term "mines" to include deposits of waste or residue of mines. The effect of this was to extend depletion to the extraction of ores or minerals from waste or residue of prior mining.

2. Special rules for apportioning the deduction for depletion (*sec. 611*(*b*))

The apportionment of depletion between lessor and lessee has been in the law since the Revenue Act of 1918. The House committee report on that act stated that the bill corrected an inequality by providing for equitable apportionment of the depletion allowance between lessor and lessee. Obviously, both parties were having their capital in the natural resources depleted.

At the same time Congress granted discovery depletion (now percentage depletion) as an inducement "to stimulate prospecting and exploration." Such activities, with accompanying risk of the capital involved, are usually undertaken by lessees and only rarely by lessors.

At the instance of the Finance Committee, and in order to remove uncertainty and hardship, a provision was put into the Revenue Act of 1928 providing for depletion allocation between life tenant and remainderman—to be computed as if the life tenant were the absolute owner with the deduction allowed to him. As between trustee and beneficiary, that act provided that the depletion deduction should be governed by the trust instrument; but in the absence of pertinent provisions therein, on the basis of the trust income allocable to each.

In the 1954 Code a provision relating to estates was added. It provides for apportionment of the depletion deduction between estates and beneficiaries on the basis of the income allocable to each.

3. Percentage depletion (*sec. 613*(*a*))

The forerunner of percentage depletion was "discovery depletion"—introduced by the Revenue Act of 1918. Congress intended to "stimulate prospecting and exploration" by permitting a deduction for the capital being exhausted by production. This deduction was based on a "discovery value," where the fair market value at the time of discovery, or 30 days thereafter, was materially disproportionate to cost. Because this allowance was at times used to offset income from unrelated business activities, the 1921 act limited the deduction to net income from the particular property, computed without the deduction for discovery depletion, but not less than depletion based on cost or March 1, 1913, value. Experience showed the "net income" limitation to be insufficient, and in the 1924 act the limitation was further reduced to 50 percent of net income from the property.

The Revenue Act of 1926 was the first to allow percentage depletion, as a substitute for discovery depletion, but it limited the allowance to oil and gas wells. A showing of "discovery" was no longer required. The allowance was then and at present still is 27½ percent of gross income from the property, with the 50 percent of net income (now taxable income) limitation. The conference report explained that administration of discovery depletion was very difficult in the case of oil and gas wells; therefore, percentage depletion was permitted instead in the interest of simplicity and certainty in administration. The act continued discovery depletion for mines.

The 1932 act extended percentage depletion to metal, sulfur, and coal mines—at the rate of 15 percent of gross income from the property for metals, 23 percent for sulfur, and 5 percent for coal—all with a comparable 50-percent limitation on taxable income from the property. (In 1951 the rate for coal was changed to 10 percent.) Discovery depletion on metal, sulfur, and coal mines was no longer permitted.

Percentage depletion, instead of discovery depletion, was made applicable to fluorspar, ball and sagger clay, and rock asphalt by the Revenue Act of 1942. This act, although not retroactive, eliminated for years subsequent to December 31, 1941, the election to claim percentage depletion. Thus depletion on either a percentage or a cost basis, whichever is greater, was allowable.

Under the Revenue Act of 1943 a new group of nonmetallics were added to the percentage depletion provision at a rate of 15 percent. These included flake graphite, vermiculite, potash, beryl, feldspar, mica, lepidolite, spodumene, talc, and barite. At the same time discovery depletion was excluded. Except for potash, the allowances were limited to the duration of World War II.

In 1947 the World War II limitation was repealed, retroactive to the date of enactment. This made the 1943 allowances permanent. Additional nonmetals were added to the percentage depletion list and discovery depletion denied them. Those included, among others, were bauxite, china clay, phosphate rock, and bentonite.

In the Revenue Act of 1951 other minerals and natural deposits such as sand, gravel, slate, oyster shells, etc., were included at a 5-percent depletion rate.

Under the 1954 Code discovery depletion has been entirely eliminated; all minerals and natural resources are permitted percentage depletion, at varying rates and with the 50 percent of taxable income limitation. Soil, sod, dirt, turf, water, mosses, and minerals from sea water, air, or similar inexhaustible sources are specifically excluded. A tabulation of the minerals and natural resources is set forth in code subsection 613(b) together with the applicable percentage depletion rates.

4. Definition of gross income from property—mining (*sec. 613*(*c*))

In 1943 a retroactive provision was enacted with respect to mines; this provision defined "gross income from the property" (other than an oil or gas well) to mean "gross income from mining." In addition to the extraction of ores or minerals from the ground, "mining" was defined to include the ordinary treatment processes a mine owner or operator normally applies to obtain a marketable product. The 1943 act sets forth four categories of ordinary treatment processes to be included as mining.

The definition of mining for purposes of gross income was amended in 1950 to include the added value resulting from transportation of the ores or minerals from the point of extraction to plants or mills where the ordinary treatment processes are applied. Transportation is limited to 50 miles except in unusual cases. This provision was designed to prevent discrimination in cases where the first processing was done off the property.

Under the 1954 Code there were added as ordinary treatment processes, in the case of coal, dust allaying and treatment to prevent freezing. Also added were pulverization of talc, burning of magnesite, and sintering and nodulizing of phosphate rock. The Finance Committee in its report noted that other processes will be allowed or disallowed as "ordinary treatment processes" under the general provision in subsection 613(c).

The 1954 Code, applicable to future years, also enlarged the phrase "extraction of the ores or minerals from the ground" to include extraction of ores and minerals from the waste or residue of prior mining. Court decisions under earlier law had held to the contrary. The inclusion of these recoveries as part of mining is limited to owners or operators of properties, and is not applicable to purchasers who make similar recoveries from such waste or residue.

5. Definition of property—aggregation of mineral interests (*sec. 614*)

Although depletion must be computed by properties, there was no statutory definition of a "property" until enactment of the 1954 Code. The regulations under the 1939 Code had defined the taxpayer's interest in each separate mineral property as a separate property, and had specified that, where two or more mineral properties are included in a single tract of land, the interest in such mineral properties can be considered as a single property.

Under the 1954 Code a property is each separate interest owned by the taxpayer, in each mineral deposit, in each separate parcel of land. Tracts of land can be separated either geographically or by conveyance; this was also the administrative interpretation under prior law.

The 1954 Code also provides special rules for so-called "operating mineral interests" and "nonoperating mineral interests." An "operating mineral interest" is one in respect of which costs of production are required to be taken into account in computing the 50-percent limitation in determining percentage depletion. "Nonoperating mineral interests" are defined to be those which are not "operating mineral interests," and thus would include royalty interests. In addition, the term "operating unit" refers to a group of operating mineral interests that may conveniently and economically be operated as a single unit.

An election was granted in the 1954 Code to aggregate two or more operating mineral interests as one property, if the aggregation constitutes part or all of an operating unit. Not more than one aggregation can be formed within one operating unit, and any operating interest that is not aggregated must be treated as a separate property. The interests need not be in a single tract or parcel of land or even contiguous.

In the Technical Amendments Act of 1958 a new set of rules for aggregation, applicable to operating mineral interests (except oil and gas wells) and to all nonoperating mineral interests, are set forth.

The new rules for operating mineral interests (except oil and gas wells) permit any number of aggregations within an "operating unit" (instead of one permitted by the 1954 Code) so long as each aggregation contains all of the interests that comprise a complete mine or mines. Any mineral interest which subsequently becomes part of an aggregated mine must also be included. In addition, where a single mineral deposit, representing a single mineral interest, is being developed or operated by two or more mines, such mineral interest can be treated as more than one property.

Under the 1954 Code the election to aggregate operating mineral interests must be made in the return for whichever year of the following is later: (1) the first taxable year after December 31, 1953; or, (2) the first taxable year in which expenditures for *exploration*, development, or operation are made by the taxpayer after acquiring the operating mineral interest. Under the Technical Amendments Act of 1958, such an election to aggregate operating mineral properties, in the case of mines, can wait until the time of the first *development* expenditure, as distinguished from the first *exploration* expenditure previously required.

As to nonoperating mineral interests, the 1954 Code provides that aggregation can be made if the separate interests are all nonoperating mineral interests. Further, such interests must be in a single tract of land or in contiguous tracts; consent must be received from the Secretary or his delegate upon a showing of undue hardship. These requirements were relaxed in the Technical Amendments Act of 1958 to permit nonoperating mineral interests to be aggregated if such interests are adjacent (in reasonably close proximity to each other) rather than contiguous. A further modification permits the taxpayer to make a showing that a principal purpose of the aggregation is not tax avoidance, instead of a showing of undue hardship.

The Technical Amendments Act of 1958 also provides, in the case of oil and gas wells, that any taxpayer may treat such properties as if the rules under the 1939 Code continued to apply, and that subsections 614(a), definition of property, and 614(b), special rule as to operating mineral interests, in the 1954 Code had not been enacted. However, if such treatment constitutes an aggregation under subsection 614(b) of the 1954 Code, then such treatment shall be taken into account in applying 614(b) to other property of the taxpayer.

6. Exploration expenditures—mines and other natural deposits, except oil and gas wells (sec. 615)

Prior to 1951 exploration expenditures, made for ascertaining the existence, location, extent, and quality of mineral deposits, had to be capitalized and recovered through the depletion allowance. If such expenditures produced no useful results, they could, of course, be deducted as a loss. When percentage depletion is applicable, the deduction is the same whether a large or a small sum has been spent for exploration. Thus, there was no special tax incentive for increased exploration expenditures.

The Revenue Act of 1951, in recognition of the deficiency in available mineral resources and the demands of our economy, especially during emergency periods, authorized a tax deduction for exploration expenditures with respect to mineral deposits. It was believed that intensified efforts to find new deposits were highly desirable. Such expenditures have to be paid or incurred prior to the time the mine reaches the development stage, and the deduction is limited to a total of $75,000 paid or incurred in any one taxable year. Further, such deductions can be claimed in 4 taxable years only, whether or not the entire $75,000 is allowed as a deduction in any or all of such years. This 4-year limitation also includes any year in which deductions were allowed a prior owner, if a property or properties were received by the taxpayer in certain tax-free transactions requiring the use of a substituted basis.

A taxpayer may elect in any of the 4 years to defer, rather than deduct, any amount paid or incurred up to $75,000 and to deduct such amount ratably as the ores or minerals discovered by the expenditure are sold. Such deferrals will be taken into account in computing adjusted basis of the mine or deposit, but will be disregarded in computing cost depletion.

This amendment is applicable to taxpayers who have paid or incurred exploration expenditures and has no application to the cost of a mine or deposit, attributable to such expenditures, when acquired by purchase. Expenditures to acquire depreciable property are not deductible, but appropriate depreciation allowances will be considered as such expenditures.

In the 1954 Code the limitation for each of the 4 years was increased from $75,000 to $100,000. This increased deduction is not fully applicable if deductions were allowed or deferred for any prior year or years under the 1951 amendment. The 1954 Code also makes applicable the 4-year limitation if a corporate taxpayer under subsection 381(c)(10) (relating to carryovers in certain corporate transactions) is entitled to deduct expenses deferred by its corporate transferor.

In 1960, the provision for the deduction or deferral of exploration expenditures was amended by removing the 4-year limitation and substituting a $400,000 limitation. The annual limitation continues to be $100,000, but a taxpayer may continue to treat exploration expenditures under section 615 until $400,000 has been treated under that section, irrespective of the fact that the taxpayer deducts or defers exploration expenditures in more than 4 years.

7. Development expenditures—Mines and other natural deposits, except oil and gas wells (sec. 616)

Development expenditures for mines are those expenditures incurred after the existence of ores or minerals in commercially marketable quantities has been determined and the development stage begun.

The production stage of a mine is reached when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine becomes the production of developed ore rather than the development of additional ores for mining.

Prior to 1951 there existed no specific statutory enactment relating to the treatment of development expenditures of mines or other natural deposits. Treasury regulations relating to such expenditures provided in essence that: (1) Development expenditures in excess of net receipts from sales of ores or minerals must be capitalized and recovered through cost depletion; (2) after the mine reaches the production stage, all development expenditures are to be treated as operating expenses and deductible in the year of sale of the ores or minerals; (3) if such expenditures are extraordinary, they are treated as prepaid expenses to be deducted ratably as the ore is produced and sold.

Beginning with the Revenue Act of 1951, a more favorable tax treatment is permitted. It was believed that development expenditures were essentially similar to those incurred after the production stage was reached and that mines with large development costs were subjected to unfair discrimination. This requirement to capitalize was presenting a serious obstacle to expansion. Congress believed the requirement especially serious in 1951 because of the shortage of many essential minerals and the desirability of major developments necessary to the defense effort.

The Revenue Act of 1951 changed existing law with respect to expenditures in the development of a mine or other natural deposit (other than an oil or gas well). It permitted the taxpayer to elect either (1) to deduct such expenditures in the year incurred, whether before or after the production stage is reached, or (2) to treat such expenditures as deferred expenses to be deducted ratably as the ore or mineral is sold. This election is annual, but must be for the total amount of net development expense with respect to a particular mine. If the taxpayer so elects to defer development expenditures, the amounts deferred will be taken into account in determining the adjusted basis of the property for computing gain or loss, but they will not be taken into account in computing cost depletion.

The act of 1951 is applicable to a taxpayer who has paid or incurred such expenditures; it has no application to the cost of a mine or deposit attributable to such expenditures when acquired by purchase. Expenditures for improvement of property of a character subject to depreciation will not qualify as development expenditures. However, allowances for depreciation shall be considered as development costs.

The changes enacted in the 1951 act also carry over into the present 1954 Code.

It is to be noted that intangible drilling and development costs in the case of oil and gas wells are deductible at the option of the taxpayer under section 263(c) of the 1954 Code. This option was granted to taxpayers by Treasury regulations prior to 1954.

Part II—Exclusions From Gross Income

1. *Payments to encourage exploration, development, and mining for defense purposes* (*sec. 621*)

This provision originated in the Excess Profits Tax Act of 1950, enacted at the time of the Korean conflict. It was intended as a stimulant to the extractive industries during the then current emergency. The act exempted from both income and excess profits taxes amounts paid, under certain circumstances, by the United States or by any of its agencies or instrumentalities for the encouragement of exploration, development, or mining of critical and strategic minerals or metals. This exclusion from income was effective for years beginning after December 31, 1950, and related to payments, whether by grant or loan, and whether or not repayable or forgiven. Expenditures attributable to such grants or loans could not be deducted by the taxpayer; nor could the basis of his property be increased, except that any portion of a grant or loan, expended in accordance with its terms and repaid, would be allowed as a deduction or an increase to basis at the time of repayment.

The 1954 Code has continued this provision with no change in substance.

Part III—Sales and Exchanges

1. *Gain or loss in the case of timber or coal* (*sec. 631*)

Prior to 1943 income from cutting timber was taxed as ordinary income. A taxpayer who cut and sold his own timber lost the benefit of the capital gain rates which were applicable if he sold the standing timber outright. In enacting the Revenue Act of 1943, Congress authorized capital gains treatment. The denial of this treatment was described in the Finance Committee report as a handicap and a discrimination.

Taxpayers were permitted to elect to treat the cutting of timber (for sale or for use in the taxpayer's trade or business) as a sale or exchange of property. The cutting had to be done in the taxable year, and the taxpayer had to own, or have a contract right to cut, such timber (in either instance for a period of more than 6 months prior to the beginning of such year). If such election was made, the gain or loss to be recognized was the difference between the adjusted basis for depletion and the fair market value of the timber on the first day of the taxable year in which the timber was cut. This fair market value was considered the taxpayer's cost for all purposes where cost was a necessary factor. Further, the election was applicable to all timber owned by the taxpayer or which he had a contract right to cut, and was binding for future years, unless the Commissioner, on a showing of undue hardship, permitted a revocation of the election.

The Revenue Act of 1943 added a further provision relating to the disposal of timber by an owner who, by contract, retains an economic (royalty) interest. Such a disposal was considered as a sale and entitled to capital gains treatment. A holding period of more than 6 months was required, and the recognized gain or loss was the difference between the amount received and the adjusted basis for depletion.

The Revenue Act of 1951 extended this provision to coal royalties. Congress recognized that coal leases are long term; that the royalties, being expressed in cents per ton, do not share in price increases; and that such royalties, from a practical viewpoint, do not benefit from percentage depletion. In granting capital gains treatment to coal royalties, the 1951 act defined coal as including lignite, denied percentage depletion to such royalties, and deemed the date of mining to be the disposal date.

In the Revenue Code of 1954 "timber" includes evergreen trees which are more than 6 years old at the time severed from the roots and sold for ornamental purposes. For royalty purposes, the date of disposal of timber is deemed to be the date the timber is cut, but if payment is made to the owner under contract prior to such cutting, the owner can elect to treat the date of payment as the date of disposal. "Owner" is defined to mean anyone who owns an interest in timber, including a sublessor and a holder of a contract to cut timber.

In the case of coal, the 1954 Code provides that certain expenditures, attributable to the making and administering of the royalty contract or the preservation of the economic interest, are to be added to the adjusted basis for depletion in determining gain or loss. An "owner" of coal also includes a sublessor.

2. Sale of oil or gas properties (sec. 632)

This provision is a limitation on the tax to be paid on the sale of an oil or gas property when the principal value thereof results from prospecting, exploration, or discovery. It was introduced in the Revenue Act of 1918 to stimulate prospecting and exploration and in recognition of the fact that taxpayers often spend many years and much money in fruitless efforts to find oil and gas. The Finance Committee report stated it to be unwise and unfair to tax the profit on such a sale at maximum rates as if it were ordinary income attributable to normal activities of a single year. The provision limited the surtax rate to 20 percent.

In the Revenue Act of 1934 this section was omitted, as Congress did not believe the then "state of overproduction" justified its continuation. However, the omission acted as a deterrent to sales by individuals and a consequent loss to the revenue.

In the Revenue Act of 1936 the provision was reenacted with a surtax limitation of 30 percent, which is the rate in the present 1954 Code. The Finance Committee noted that such enterprises were being taken over by corporations because of the lower corporate tax rate. It was believed the reenactment would stimulate individuals to develop oil and gas properties and to sell them, thus increasing the tax yield.

SUBCHAPTER M. REGULATED INVESTMENT COMPANIES

1. Definition of regulated investment company (*sec. 851*)

The philosophy behind subchapter M is the elimination of an extra layer of taxation on income received by regulated investment companies and distributed by them to their shareholders. In the absence of these special provisions, the income would be taxed once in the hands of the investment companies and again in the hands of their shareholders. The development of these special provisions has involved extending "conduit" treatment to income distributed by investment companies, and at the same time providing "qualifying tests" to forestall abuse of the provisions. Conduit treatment enables the investor of moderate means to obtain, without substantial tax disadvantage, the benefits of diversification of risk.

Prior to 1936 some investment companies were treated as trusts—with the result that they were not taxed on current income distributed to shareholders. Others, which were treated as associations (and hence considered to be corporations) were not taxed on that portion of income representing intercorporate dividends received. Two developments in 1935 affected the tax status of investment companies: (1) The revenue act of that year imposed a tax on 10 percent of intercorporate dividends (increased to 15 percent in 1936); and (2) a series of court decisions made the test for qualifying as a "trust" for tax purposes more stringent.

These developments led to the inclusion in the Revenue Act of 1936 of the first provisions dealing specifically with investment companies. The provisions were limited to mutual investment companies of the open-end type which distributed 90 percent or more of their income, and met certain other tests relating to source of income, type and extent of investments, and diversification. Personal holding companies were specifically excluded.

Passage of the Investment Company Act of 1940 paved the way for extending the special tax treatment of "mutuals" to other categories of investment companies. In its consideration of that act, the House Committee on Interstate and Foreign Commerce noted that "the tax problem is very pressing with respect to closed-end management investment companies." These companies did not qualify as mutual investment companies under the 1936 act because they did not permit the shareholder to redeem his proportionate interest in the company. The Excess Profits Act of 1940 exempted "mutuals," as well as those diversified companies which were registered under the Investment Company Act of 1940, from the excess profits tax.

Major changes in the qualifying tests were finally enacted in the Revenue Act of 1942; these have carried over, with slight modifications, to the 1954 Code. The special income tax treatment previously given to "mutual investment companies" was extended to "regulated investment companies" that are registered under the Investment Company Act of 1940 and also to certain common trust funds.

The tests for qualifying were liberalized. The requirement that shareholders be entitled to redeem their proportionate interest in the company was eliminated. Indebtedness in excess of 10 percent of assets will not disqualify. The gross income requirement (95 percent from dividends, interest, and gains) was reduced to 90 percent; the short-term capital gains limitation was liberalized by reducing the 6 months holding period to 3 months.

The inclusion of additional types of investment companies also led to changes in the diversification tests. These were designed to deny special tax treatement to ordinary holding companies. Under these new tests at least 50 percent of the company's assets must be represented by cash, Government bonds, securities of other regulated investment companies, or securities of other companies (limited to 5 percent of the investment company's assets and to not more than 10 percent of the outstanding voting securities of any one issuer). In no event could more than 25 percent of assets be invested in any one company or in controlled companies engaged in the same or similar business.

Since 1941 the taxpayer must make an irrevocable election to be treated as a regulated investment company under supplement Q of the 1939 Code or subchapter M of the 1954 Code.

The Revenue Act of 1951 added an exception (subsec. 851(e)), to the qualifying tests; this was designed to permit venture capital companies to qualify even though they invest more than 10 percent in one company. Such companies must provide capital for other companies engaged in development or exploitation of inventions, technical improvements, and new processes or products. They must meet certain tests designed to forestall abuse of the new provisions. This exception was justified on the ground that venture capital companies provide a means for diverting current savings into new ventures which are deemed important for long-term economic growth.

2. *Requirements for taxation as a regulated investment company (sec. 852(a))*

This subsection has two objectives: (1) To encourage a regulated investment company to distribute its income; and (2) to insure that the provisions of subchapter M are not available to personal holding companies.

The first objective is achieved by taxing the regulated investment company as an ordinary corporation (with a special rule for computing earnings and profits) in the event it does not distribute 90 percent or more of its taxable income, exclusive of capital gains.

The second objective is met by requiring the company to comply with the recordkeeping requirements that the Commissioner may prescribe to show whether more than 50 percent of its voting stock is held, actually or constructively, by five or fewer individuals.

The requirements of this subsection were included among the prerequisites for classification as a mutual investment company under the 1936 act. They were removed as prerequisites for classification as a "regulated investment company" under the 1942 revision of the 1939 Code. Instead, they were prescribed as a requirement for "pass through" or conduit treatment of the company's income. This change was made in conjunction with adoption of the concept of earnings and profits in 1942 which provided, in effect, that capital losses could not reduce current earnings and profits. This meant that a regulated investment company was subject to the special earnings and profit concept even though conduit taxation was denied because of failure to meet the requirements of distribution and "disclosure" of actual ownership.

The reason for applying the special earnings and profits concept when the company did not qualify for conduit treatment was to prevent switching back and forth between ordinary and conduit taxation. In the absence of this rule, a company with unrealized capital losses could make tax-free distributions by taking such losses in a year when the pass through requirements were not met.

This principle was inadvertently omitted in drafting the 1954 Code. The effect of the omission was to exempt the company from all provisions of subchapter M of the 1954 Code if it did not qualify for conduit taxation. The Technical Amendments Act of 1958 restored the principle of the 1939 Code for taxable years after February 28, 1959.

3. Method of taxation of regulated investment companies and their shareholders (sec. 852(b))

The provisions of this subsection specify the procedure and method for giving effect to the conduit taxation of income received by a fully qualified company.

Ordinary income distributed to shareholders is included in their gross income. The remaining undistributed taxable income is taxed to the company, as in the case of a corporation, under section 11.

Capital gains distributed to shareholders are taxed to them as long-term capital gains. This pass through of capital gains was first permitted by the 1942 Revenue Act and was intended to accord the investment company shareholder the same treatment he would have received if he had invested in securities directly.

Undistributed capital gains were taxed to the company at the 25-percent rate under the 1942 act. Since December 31, 1956, "constructive" distribution of these gains has been permitted. Under this procedure the company pays the tax and passes it on to the shareholder as a credit. The shareholder's proportionate share of the total capital gain income is deemed for tax purposes to have been received by the shareholder.

The Technical Amendments Act of 1958 modified the general rule for treatment of capital gains by the shareholder. The revision provides that if the investment company's shares are held for less than 31 days, any resulting loss from their sale shall be treated as a long-term capital loss to the extent of any capital gain dividend received, either actually or constructively. This rule was directed at a tax avoidance scheme made possible by the fact that capital gains distributions by a regulated investment company were considered long-term capital gains even though the company's shares are held for only a few days. For example, a security dealer could buy company shares just before a capital gain dividend became payable and could sell them at a loss immediately after the dividend payment. If the shares were held in the dealer's inventory account, the loss would be deductible from ordinary income. If they were held in an investment account, the loss would be treated as a short-term capital loss and used to offset short-term capital gains. In either event the dividends were treated as long-term capital gains. The new rule requires that the loss be reduced to the extent capital gain dividends were received, either actually or constructively.

4. Earnings and profits of a regulated investment company (subsec. 852(c))

This provision harmonizes the computation of taxable income and earnings and profits by precluding the reduction of earnings and profits by any amount which is not allowable as a deduction in computing taxable income. This concept of earnings and profits originated in section 170 of the Revenue Act of 1942 which also applied the concept retroactively to tax years beginning with 1936.

The adoption of this earnings and profits concept stemmed from the fact that net losses of more than 10 percent, which were deductible in computing earnings and profits but not net income, would disqualify a company for conduit taxation because it would not then be able to distribute 90 percent or more of its net income as taxable dividends.

The last sentence of this subsection was added by the Technical Amendments Act of 1958. The effect of this sentence was to restore the principle of the 1939 Code that a regulated investment company's earnings and profits would be computed under this special earnings and profits concept even though it failed to qualify for conduit taxation.

5. Foreign tax credit to shareholders (sec. 853)

This section, enacted in 1954, extends conduit treatment to taxes paid to a foreign government.

It seeks to overcome the disadvantage of the regulated investment company shareholder compared to the individual who invests directly in stock and securities of a foreign corporation and receives the benefit of the foreign tax credit. Because a regulated investment company is required to distribute most of its income, it does not pay sufficient income taxes to make full use of the foreign tax credit. Moreover, the deduction by the company of the foreign taxes paid reduces the amount of income available for distribution to shareholders as dividends.

In order for the shareholder to qualify for the benefits of this section, the company must elect to have the credit passed on to him. The company itself must have more than 50 percent of the value of its assets invested in stocks and securities of foreign corporations and must meet the requirements of subsection 852(a). If a company meets all the requirements, the shareholder is, in effect, placed in the same position as a person directly owning stock or securities in foreign corporations.

6. Limitations on dividends received by regulated investment company shareholders (sec. 854)

The purpose here is to insure, within allowable tolerances, that both the dividends-received deduction for corporations and the dividend exclusion and credit for individuals are available *only* to that portion of the regulated investment company's distributions which actually represent dividend income. If more than 75 percent of the company's income, exclusive of capital gains, is represented by nondividend income, the shareholder must prorate the distribution so as to reflect only the dividend income which would be allowed as a credit, exclusion, or deduction if received directly.

Thus dividend income representing capital gains, interest, or dividends from a foreign corporation would be considered nondividend income.

The limitations date from 1954, when the dividend exclusion and credit were extended to individuals. Prior to that time corporations were taking the usual 85-percent dividends-received deduction on distributions from regulated investment companies. In many cases such distributions represented interest income in the hands of the investment company. Thus, this interest income was not being fully taxed, because it was taken as a deduction by the issuer of the bonds and was nontaxable to the investment company. Section 854 closed this loophole.

7. Dividends paid after close of taxable year (*sec. 855*)

This provision was enacted in 1950 to give relief to those companies having difficulty in determining what constituted 90 percent of their income before the end of their taxable year. The difficulty arose from the receipt of substantial dividend income at, or near, the end of the year. If their taxable income was not accurately determined, so that 90 percent of it could be distributed by the end of the taxable year, they would be denied conduit treatment of such income.

This section gives the company a grace period so that if it declares a dividend after the close of the taxable year and before the legal filing time, it may elect to treat such dividend as having been paid during the taxable year.

In the event the company makes the election under this section, its shareholders will be taxed on the dividend in the year in which received.

SUBCHAPTER N. TAX BASED ON INCOME FROM SOURCES WITHIN AND WITHOUT THE UNITED STATES

Part I—Determination of Sources of Income

1. Income from sources within the United States (*sec. 861*)

This provision dates from 1916. Prior to that time, the statutes imposed a franchise tax on the net income of nonresident aliens from all property owned and from every business, trade, or profession carried on in the United States. This section was adopted to provide a firm basis for taxing nonresident aliens and foreign corporations on the "source" or origin of the income and the situs of the activities or property which produces the income. It was designed, on the one hand, to prevent nonresident aliens and foreign corporations from deriving certain adequately defined types of income from the United States free from tax, and, on the other hand, to prevent undue imposition of a tax on income from activities which do not take place in and from property not employed in the United States. Income from sources within the United States is taxed on the theory that the Government has jurisdiction over this income, grants protection to the creation of such income, and is entitled to a share thereof to defray Government expenses.

2. Income from sources without the United States (*sec. 862*)

This provision was made specific in 1921. The 1921 act continued the theory of taxing nonresident aliens and foreign corporations on income from "sources within the United States", and it greatly enlarged the definition of the term, defining specifically (*a*) what should be included in the term, and (*b*) what should not be included in the term, i.e., this present section.

3. Items not specified in section 861 or 862 (*sec. 863*)

This section also dates from 1921; it was adopted to clarify the law relating to "sources within the United States" and to give recognition to a specific class of income—that which is from "sources partly within and partly without the United States". This section also provides for the allocation and apportionment of items of gross income and deductions to sources within or without the United States.

4. Definitions (sec. 864)

The 1921 act provided for the precise definitions of terms to facilitate the designation of income from within or without the United States.

Part II—Nonresident Aliens and Foreign Corporations

SUBPART A—NONRESIDENT ALIEN INDIVIDUALS

1. Tax on nonresident alien individuals (section 871)

This provision dates from 1936. The rate of tax and method of collection now depend on whether or not the nonresident alien is engaged in trade or business in the United States and the amount of income from U.S. sources. Congress believed that this type of treatment would bring in more revenue and eliminate the many defects which permitted nonresident aliens to avoid taxation and to secure unfair advantages over citizens. In its present form this section attempts to achieve greater equality between nonresident aliens and American citizens and residents in the upper brackets.

2. Gross income (sec. 872)

Gross income includes only gross income from sources within the United States.

This section dates from 1918. Congress broadened the gross income definition of the 1913 act to specify that in the case of nonresident alien individuals, gross income also included all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States. Prior to this time, profit from the sale in the United States of goods manufactured abroad was not included in gross income from sources within the United States. This section proposed to make foreign corporations include such profits in their gross income from within the United States if they sell in the United States either the product itself or the raw materials to be manufactured here under an agreement that certain profits on the manufacture and disposition shall be paid to the foreign corporation.

3. Deductions (sec. 873)

This section also dates from 1918. Congress wanted to specify that, in the case of nonresident alien individuals, deductions are allowed only to the extent that they are connected with income from "sources within the United States." At the present time deductions are allowed to nonresident aliens and foreign corporations engaged in trade or business in the United States; but since the 1942 act deductions are not allowed to individuals or corporations not engaged in trade or business in the United States (with a few exceptions).

4. Allowance of deductions and credits (sec. 874)

This provision has been effective since 1921. This rule requires a nonresident alien to file the required return, disclosing his income for the taxable year from sources within the United States, as a prerequisite for the allowance of deductions and credits. The filing of a return thus gives the taxpayer the benefits of taxation on net income; otherwise he will be subject to normal and surtax rates on gross income.

5. Partnerships (sec. 875)

This provision goes back to 1936; it states that the taxability of a nonresident alien individual who is a member of a partnership depends upon the U.S. activities of the partnership. A sufficient involvement in U.S. transactions by any one partner may cause the partnership, and consequently the other partners, to be regarded as engaged in business in the United States.

6. Alien residents of Puerto Rico (sec. 876)

See section 933, income from sources within Puerto Rico.

7. Foreign educational, charitable, and certain other exempt organizations (sec. 877)

See section 512(a).

SUBPART B—FOREIGN CORPORATIONS

1. Tax on foreign corporations not engaged in business in the United States (sec. 881)

Tax on resident foreign corporations (sec. 882)

These sections date from 1936 when Congress revised the treatment of nonresident aliens and foreign corporations to eliminate the opportunities for tax evasion and avoidance and to increase income tax revenue. This act divided foreign corporations into two classes: (1) nonresident foreign corporations, section 881, those foreign corporations not engaged in trade or business in the United States, and (2) resident foreign corporations, section 882, those foreign corporations engaged in trade or business within the United States at any time during the taxable year. The resident foreign corporation is taxable at regular corporate rates on its net income from all sources within the United States, and it may take the deductions provided by the code. A nonresident foreign corporation is taxable at a rate of 30 percent—by withholding at source with respect to its gross income from sources within the United States consisting of interest, rents, and dividends, and certain other named items—and this nonresident corporation is not allowed deductions from gross income.

2. Exclusions from gross income (sec. 883)

This provision, which was designed to encourage the international adoption of uniform laws affecting shipping companies for the purpose of elimination of double taxation, was introduced in 1921. This section provides a reciprocal exemption with regard to earnings derived from operation of ships under foreign registry. An amendment to the 1939 Code effective for the taxable year beginning after December 31, 1945, included aircraft under foreign registry. This provision covers only companies whose country grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

SUBPART C—MISCELLANEOUS PROVISIONS

1. Doubling of rates of tax on citizens and corporations of certain foreign countries (sec. 891)

This provision, which was designed to prevent foreign nations from levying discriminatory or extraterritorial taxes upon American citizens, was introduced in 1934. Under this section the President has the retaliatory power to double the tax rates in the case of each citizen and corporation of a foreign country which is discriminating against U.S. citizens. This tax is limited to an amount not in excess of 80 percent of the foreign taxpayers' net income, to prevent actual confiscation of foreigner's income.

2. Income of foreign governments and of international organizations (sec. 892)

This section, which dates from 1918, exempts from taxation the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities. Governments grant each other exemptions and immunities such as this, as a matter of comity. This exemption was extended in 1945 to include international organizations, at a time when the United States was increasing its participation in such organizations.

3. Compensation of employees of foreign governments or international organizations (sec. 893)

This section, which dates from 1934, exempts from tax on a reciprocal basis the compensation of employees of foreign governments. Since 1945 this exemption has included the compensation of employees of international organizations as an extension of governmental immunities. This exemption does not apply to employees who are citizens of the United States.

4. Income exempt under treaty (sec. 894)

This section, which dates from 1936, provides that income of any kind, to the extent required by any treaty obligation of the United States, shall be excluded from gross income and exempt from tax. This provision was enacted to bring the tax law into accord with tax treaties which eliminate international double taxation of business activities.

PART III—INCOME FROM SOURCES WITHOUT THE UNITED STATES

SUBPART A—FOREIGN TAX CREDIT

1. Taxes of foreign countries and of possessions of the United States (sec. 901)

The credit for income taxes paid abroad dates from 1918; it was designed to eliminate double taxation of income. Prior to this time, a deduction from gross income had been allowed for foreign income taxes.

2. Credit for corporate stockholder in foreign corporation (*sec. 902*)

Prior to 1921, only American corporations with foreign branches were entitled to the foreign tax credit. In 1921 Congress extended the foreign tax credit to a domestic corporation which owned a majority of voting stock in a foreign subsidiary. In general, this credit continued unchanged until 1942 when Congress expanded it to allow domestic corporations a credit for taxes paid by a wholly owned foreign subsidiary of the majority owned foreign subsidiary.

In 1951 Congress further liberalized this provision by allowing the tax credit to a domestic corporation which owns at least 10 percent of the voting stock of a foreign subsidiary from which it receives dividends. It also provided that such a 10-percent-owned corporation which owns 50 percent or more of the voting stock of another foreign corporation, from which it receives dividends, shall be regarded as having paid a proportion of the taxes paid by the other foreign corporation to any foreign country.

3. Credit for taxes in lieu of income, etc., taxes (*sec. 903*)

This provision, which dates from 1942, was enacted to give American foreign investors the benefit of the credit for taxes in lieu of net income taxes otherwise generally imposed by foreign countries. American investors abroad were subject to various forms of taxes, substituted for generally applicable income taxes, for which they received no credit. Consequently this provision was an attempt to provide more nearly uniform treatment in this area.

4. Limitation on credit (*sec. 904*)

The limitation on the foreign tax payments allowed as a credit against the U.S. tax dates from 1921. This was the "overall" limitation which restricted the credit so that it would not exceed the same proportion of the total U.S. tax as the income from foreign sources bears to the total income of the taxpayer. This limitation was imposed to prevent the U.S. tax on domestic income from being reduced by foreign rates which are higher than the U.S. tax rates.

The 1932 act added the "per country" limitation which specifies that, with respect to taxes paid to each country, the credit should not exceed the proportion of the U.S. tax which the taxpayer's income from within such country bears to his entire net income. This limitation was written in to eliminate a tax benefit received by some taxpayers deriving income in more than one country as compared with other taxpayers operating in only one country.

Both of these limitations were in effect until the 1954 Code eliminated the "overall" limitation.

5. Year in which credit taken (*sec. 905a*)

This section, which dates from 1924, provides that at the taxpayer's option the credit may be taken in the year in which the taxes of the foreign countries or possessions of the United States accrued, irrespective of the accounting method. Prior to this time the statutes required the taxpayer to take the credit on either a cash or an accrual basis depending on the accounting method which was used.

SUBPART B—EARNED INCOME OF CITIZENS OF THE UNITED STATES

1. Earned income from sources without the United States (sec. 911)

This section dates from 1942. Prior to this time and since 1926, a citizen of the United States who was a nonresident for more than 6 months during the taxable year, was nontaxable on amounts received from sources without the United States (except for amounts paid by the United States or any agency thereof) if such amounts constituted earned income. Because of the widespread abuse of this section, in 1942 Congress adopted an amendment extending the required period of residence from 6 months to the "entire taxable year" and also requiring that the taxpayer be a bona fide resident of a foreign country for that period.

In 1951 Congress amended this section to clarify and liberalize the terms of residency which were thought to have been construed rather strictly, with the result that many citizens employed abroad for extended periods of time could not avail themselves of this exclusion. To ease the problem of establishing bona fide residence, the 1951 amendments granted the exclusion with respect to earned income from sources outside the United States, which is attributable to any period of 18 consecutive months during which the citizen is physically present in a foreign country or countries for a total of at least 510 full days.

To prevent abuse of this provision by citizens who went abroad to perform highly compensated jobs for the purpose of avoiding taxation and who did not become bona fide residents of the foreign country, a 1953 amendment imposed a $20,000 limitation on such excludable earnings.

2. Exemption for certain allowances (sec. 912)

This section dates from 1943; it excludes from gross income the cost-of-living allowances granted personnel of the Government assigned to foreign duty. Congress wished to make adjustment for inflated living costs encountered by Government personnel in certain foreign countries.

SUBPART C—WESTERN HEMISPHERE TRADE CORPORATIONS (SECS. 921 AND 922)

These sections came into the code in 1942. They added a classification of domestic corporation which, at that time, was exempt from the 16 percentage point corporate surtax. At the present time such a corporation, in effect, is given a 14 percentage point tax reduction. To qualify as a Western Hemisphere trade corporation, the corporation must be a domestic corporation, all of whose business is done in any country in North, Central, or South America, or in the West Indies, and which has derived 95 percent or more of its gross income from sources without the United States for the 3-year period immediately preceding the close of the taxable year, and 90 percent or more of its gross income from the active conduct of a trade or business. Congress wanted to alleviate competitive disadvantages faced by American corporations trading in foreign countries in the Western Hemisphere. The disadvantage had become especially great by reason of the new U.S. wartime tax rates on corporations wherever operating, because the countries in which they were operating imposed relatively low taxes on their own corporations, and other countries often completely exempted from tax the foreign income of their corporations.

SUBPART D—POSSESSIONS OF THE UNITED STATES

1. Income from sources within possessions of the United States (sec. 931)

This provision, which is an exception to the general rule that citizens and domestic corporations are taxable on their entire net incomes from all sources, wherever the business is transacted or the property located, was incorporated into the 1921 act. It was Congress' intention to promote economic growth of U.S. possessions by tax relief to citizens of the U.S. resident in U.S. possessions and actively in competition there with other residents who were citizens of other countries. The present statute provides that citizens and domestic corporations satisfying certain conditions are taxable only on income from sources within the United States.

To qualify for this special treatment, 80 percent or more of gross income of such citizens or domestic corporations for the 3-year period immediately preceding the close of the taxable year must be derived from sources within a possession of the United States; and 50 percent or more of gross income for such period or part thereof must be derived from the active conduct of a trade or business within a possession of the United States. This section has no application to the Virgin Islands and does not include Puerto Rico when used with respect to citizens of the United States.

2. Citizens of possessions of the United States (sec. 932)

This section dates from 1921. It provides that a citizen of any possession of the United States shall be subject to taxation only on income derived from sources within the United States. The prevailing sentiment in Congress at that time was that exemption should be confined to income derived in U.S. possessions, in order to develop trade ties with them. The 1950 Revenue Act amended this section by excluding Puerto Rico.

3. Income from sources within Puerto Rico (sec. 933)

This section, which dates from 1950, provides that the taxpayer may exclude from gross income any income derived from sources within Puerto Rico, except amounts received for services performed as an employee of the United States or any agency thereof. As a result of this provision, all U.S. citizens who are bona fide residents of Puerto Rico during an entire taxable year will receive the same tax treatment irrespective of the origin of the taxpayer's U.S. citizenship. Prior to this change, persons made citizens of the United States by the organic acts which established the government of Puerto Rico were treated differently from those who were U.S. citizens by birth or naturalization.

SUBPART E—CHINA TRADE ACT CORPORATIONS

1. Special deduction for China Trade Act corporations (*sec. 941*)

This provision dates from the 1922 China Trade Act which authorized the creation of corporations for the purpose of encouraging the flow of investment to China. In its present form, this section provides that a China Trade Act corporation is subject to the taxes applicable to ordinary corporations, but if the corporation can meet certain requirements, a special deduction from tax on income derived from sources within Hong Kong and Formosa (not China, as under the 1939 Code) is allowed; this permits qualifying corporations to be almost completely tax exempt.

2. Disallowance of foreign tax credit (*sec. 942*)

This provision also dates from 1922. It denies China Trade Act corporations foreign tax credit against the U.S. tax. Congress wanted to put some restriction on the China trade corporations which are allowed almost complete tax exemption.

3. Exclusion of dividends to residents of Formosa or Hong Kong (*sec. 943*)

This section, which dates from 1922, provides that amounts distributed as dividends to residents of Formosa and Hong Kong (not China, as under the 1939 Code) shall not be included in gross income and shall be exempt from taxation. This concession was originally aimed at encouraging Chinese participation in China trade corporations.

SUBCHAPTER O. GAIN OR LOSS ON DISPOSITION OF PROPERTY

PART I—DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

1. Determination of amount of and recognition of gain or loss (*sec. 1001*)

This provision, in essence, was introduced in the Revenue Act of 1924 to set forth clearly the self-evident construction by the Treasury Department and the courts that the amount of gain or loss from the sale or other disposition of property was, in general, the difference between the cost or other basis of the property sold (usually an adjusted basis) and the amount realized. Beginning with the Revenue Act of 1934, the adjusted bases for determining gain or loss are not always identical. The 1954 Code added provisions prescribing the extent to which real property taxes are to be included in determining the amount realized.

PART II—BASIS RULES OF GENERAL APPLICATION

1. Basis of property—Cost (*sec. 1012*)

The essence of taxing income realized from the sale or exchange of property is that gain represents the excess of the amount realized over the "basis" (usually an adjusted basis) of the property sold or exchanged. Cost of property is such a "basis"; it has appeared in all of the taxing statutes since 1918. The statute does not define "cost," but, in general, it is applied in a popular sense; namely, the amount paid for property, either in cash or other property.

2. Basis of property acquired from a decedent (*sec. 1014*)

The 1954 Code provision, to the effect that the basis of property acquired from a decedent shall be the fair market value at time of death, originated in the Revenue Act of 1921. That act adopted an interpretation of the 1918 regulations which construed "cost," as applied to property acquired by gift, bequest, devise, or descent, to mean the fair market price at the "date of acquisition." The words "date of death" were first employed in the Revenue Act of 1928, although the term "date of acquisition" was used again in the 1939 Code—on the theory that the two terms were synonymous under the Supreme Court decision in *Brewster* v. *Gage* (280 U.S. 327). Beginning with the Revenue Act of 1942, the optional valuation date, if elected for estate tax purposes (1 year after decedent's death, or certain intermediate dates if the property has been disposed of during such year), must also be used for income tax purposes.

The 1954 Code extended the date-of-death basis (or optional valuation date) to include generally all property within the decedent's gross estate for estate tax purposes, whether or not the property is subject to probate. This would include property held jointly or gifts made in contemplation of death. The date-of-death basis does not apply to property acquired from a decedent if the recipient sells or disposes of such property prior to decedent's death. After setting forth its general date-of-death basis rule, the 1954 Code lists nine instances whereby property "shall be considered to have been acquired from or to have passed from the decedent." This section is unique in granting a stepped-up basis for income tax purposes to a successor in interest of property without incurring an income tax on the difference between the old and new bases.

3. Basis of property acquired by gifts and transfers in trust (*sec. 1015*)

As mentioned above, the basis for gifts as well as property received from a decedent was, at first, by regulation the fair market value at the time of acquisition. This became a serious source of tax avoidance, as taxpayers could give property that had increased in value to their wives or relatives, by whom it could be sold without realizing a gain. Accordingly, the 1921 act provided "a new and just rule" requiring the basis of property acquired by gift to be the same as in the hands of the donor or the last preceding owner by whom it was not acquired by gift. Later, and in order to prevent donees utilizing losses from property received by gift, the 1934 act provided that the basis of a gift for purposes of determining a loss shall be that of the donor, etc., or its fair market value, whichever is the lesser.

In following the principle as to gifts, the 1924 act provided that the basis of property acquired by a transfer in trust shall be the same as in the hands of the grantor, increased or decreased by any gain or loss recognized to the grantor on such transfer. However, since 1942 gifts in trust have not been treated as transfers in trust but are governed by the rules relating to other gifts.

These rules have been continued in the 1954 Code. The effect of them is to prevent a stepped-up basis for gifts subsequent to December 31, 1920. By the Technical Amendments Act of 1958, adjustment is made for any gift tax properly applicable; but the basis as adjusted cannot exceed the fair market value of the property at the time of gift.

4. Adjustments to basis—Substituted basis (*sec. 1016*)

As previously noted, gain or loss from the sale or other disposition of property is, in general, measured by the difference between the basis and the amount realized. "Basis," unadjusted, means the original capital investment; and "adjusted basis" means the net capital investment at any point of time when it becomes material to determine gain or loss, depreciation, etc. The various allowable adjustments to basis are enumerated in this section. They include such items as charges to capital account; allowances for depreciation, obsolescence, amortization, and depletion; tax-free distributions on stock; and amortizable bond premiums. The end in mind is to permit the return of capital tax free, but once only. Of necessity, such adjustments are specified in detail in order to fix a precise "adjusted basis."

"Substituted basis" is succinctly explained in the House report accompanying the 1932 Revenue Act, as the basis "continued or carried over from one person to another or from one piece of property to another." And—

> where there is a substituted basis or a series of substituted bases, not only the "basis" itself, but also the adjustments pertaining thereto must be continued or carried over.

5. Other adjustments to basis (*secs. 1017–1021*)

In addition to the adjustments to basis required by section 1016, there are certain special situations requiring an integration of adjustment to basis. These include the exclusion from income of the gain attributable to the discharge of indebtedness evidenced by a bond, debenture, note, etc.; this exclusion was first permitted by the Revenue Act of 1939, conditioned upon the benefited corporation consenting to a comparable reduction in basis of assets. A further exclusion from income relates to the gain of a lessor arising from the receipt of buildings or other improvements made by a lessee; this provision was introduced by the Revenue Act of 1942 to overcome the holding of the Supreme Court in *Helvering* v. *Bruun* (309 U.S. 461). Here, too, a corresponding basis provision was enacted to equalize the effect of the exclusion.

Section 1020 of the 1954 Code designated, "Election in Respect of Depreciation, Etc., Allowed Before 1952," originated in the Revenue Act of 1952 to correct the inequitable tax effects of the *Virginia Hotel* decision (319 U.S. 523), which held—

> that, where a taxpayer had claimed excessive amounts for depreciation in his returns for earlier years now closed, such excessive amounts were properly deductible from cost in readjusting the basis of the property in question, even though in those years the taxpayer had received no tax benefit from the depreciation deduction (S. Rept. No. 1160, 82d Cong., 2d sess.).

The so-called tax-benefit rule for years prior to 1952 to which the election is directed appears as section 1020 and the adjustment to basis is governed by subsection 1016(a)(2)(B).

The 1954 Code required the tax-free portion of an annuity to be spread evenly over the annuitant's life expectancy. For long-lived annuitants the tax-free recoveries could exceed the investment in the contract. For this reason section 1021 was also added, which provides that in the case of sale of an annuity contract the adjusted basis shall in no case be less than zero.

Part III—Common Nontaxable Exchanges

1. Exchange of property held for productive use or investment (*sec. 1031*)

This section of the 1954 Code has remained essentially unchanged since 1924. The existing law at that time required a tax-free exchange to be for property of a "like kind or use." Congress deleted the words "or use" in the 1924 act as too restrictive—believing it immaterial whether the property received in exchange was held for investment or for productive use. Earlier the Revenue Act of 1921 had been amended by the act of March 4, 1923 (Public Law No. 545, 42 Stat. 1560) to specifically eliminate from the tax-free category, exchanges of stocks, bonds, notes, or other evidences of indebtedness. Many brokers and investment houses had been advertising that such exchanges could be handled as nontaxable.

The House in its report accompanying the Revenue Act of 1924 stated:

> Where "boot" is given in connection with an exchange which would otherwise be tax free, the gain from the exchange shall be recognized, but in an amount not in excess of the amount of the money or other "boot".

In order to prevent tax avoidance, the 1924 act added the provision that no loss is to be recognized when "other property or money" is *received* in the exchange. However, Congress in enacting the Technical Amendments Act of 1958 noted that a loss may be recognized if nonqualified property is *transferred* together with qualified property; it amended the basis provision (sec. 1031(d)) to require an adjustment in such cases.

2. Exchange of stock for property (*sec. 1032*)

This section, which is new in the 1954 Code, provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for its stock, including treasury stock. It was enacted to remove the uncertainties caused by certain court decisions requiring gain or loss to depend upon whether the transaction constituted a dealing by the corporation in its own shares.

3. Involuntary conversions (*sec. 1033*)

The origin of this relief provision was the Revenue Act of 1921. Prior to 1942 neither gains nor losses, involuntarily realized, were recognized under either of three conditions: (1) The taxpayer could forthwith invest the proceeds of such conversion in property similar or related in service or use; (2) he could acquire control in a corporation owning such property; or (3) he could establish a replacement fund. Congress considered it inequitable to disallow losses from involuntary conversions, and in the 1942 act limited the nonrecognition to gains alone.

Several items are specifically listed as "involuntary conversions" in the 1954 Code that were not present in the 1939 Code; these include involuntary conversion of a residence, the sale of property within an irrigation district pursuant to reclamation laws, and the disposition of certain livestock because of disease or drought.

Under the Technical Amendments Act of 1958 the "nonrecognition of gain" applies if real property is converted into property of a "like kind" held either for productive use in trade or business or for investment. This is an adoption of the "like kind" rule of section 1031.

In addition, an "involuntary conversion" of a residence will be governed, at taxpayer's option, by this section or section 1034, relating to the sale or exchange of a residence.

4. Sale or exchange of residence (*sec. 1034*).

This is a relief provision which defers gain on the sale of a "principal" residence, if the taxpayer purchases another residence. Any gain is deferred to the extent that the sales price equals the cost of the substitute or "new" residence and such purchase is made within 1 year prior to the sale or within 1 year after the sale. If the "new" residence is constructed, a period of 18 months after such sale is allowed. Ownership of stock in a cooperative apartment can also serve as ownership of a residence.

This provision originated in the Revenue Act of 1951 because of the hardship occasioned by taxing illusory gains. Congress believed such sales were often involuntary, and in the 1954 Code the "involuntary conversion" section (sec. 1033) was made applicable. The 1954 Code also added an amendment which permits certain "fixing up" expenses to be deducted from the sales price of the "old" residence. Further, it suspends under certain conditions the replacement period for members of the Armed Forces, but not to exceed 4 years (existing law had a cutoff date of January 1, 1954).

As noted under sec. 1033, the Technical Amendments Act of 1958 permits the "involuntary conversion" of a residence to be governed by either this section or section 1033 at taxpayer's option.

5. Certain exchanges of insurance policies (*sec. 1035*)

This provision is new in the 1954 Code. It was added to permit individuals to exchange tax free one insurance policy for another better suited to their needs if they have not actually realized a gain. Thus, for example, the exchange of life insurance, endowment, or annuity policies for similar policies will be tax free, but the exchange of an endowment for a life insurance policy, or an annuity for a life insurance or endowment policy, will continue to be treated as a taxable exchange.

6. Stock for stock of same corporation (*sec. 1036*)

This provision originated in the Revenue Act of 1924. It treats as nontaxable the exchange of common stock for other common stock of the same corporation (or the exchange of preferred stock for other preferred stock of the same corporation) even though the exchange is not made in connection with a reorganization. The 1921 act was to the same effect prior to its amendment by the act of March 4, 1923 (Public Law No. 545). As noted under section 1031, the act of March 4, 1923, eliminated the broad tax-free status applicable to all exchanges of stocks, bonds, notes, or other evidences of indebtedness.

Part IV—Special Rules

1. Property acquired during affiliation (*sec. 1051*)

This provision originated in the Revenue Act of 1928. It authorized the issuance of "legislative" regulations by the Treasury Department for the determination of basis of property after affiliation, when such property was acquired by one corporation from another during the period of affiliation. The House report noted that such intercompany transactions are generally tax free and that it was highly important to have the basis after affiliation the same as it would have been if the property were still owned by the corporation that brought it into the affiliated group. It was believed that the transactions of this type were so varied and complex that it was impossible to prescribe by statute a definite rule of general application.

The regulations under the 1928 act required a member of an affiliated group to reduce the basis of stock of another member which it owned, if such other member had losses included in the consolidated returns and such losses could not have been availed of in separate returns.

2. Property acquired before March 1, 1913 (*sec. 1053*)

The use of the fair market value of property as of March 1, 1913, with respect to property acquired prior thereto, originated in the Revenue Act of 1916. That act required its use as a basis for determining *gain* or *loss* on disposition of property acquired prior to such date. In light of the Supreme Court decision in *Merchants Loan and Trust Co.* v. *Smietanka* (255 U.S. 509), holding, in effect, that any gain or loss accruing prior to March 1, 1913, should be excluded in computing net income, the 1921 act stated in detail the computations required in applying cost or other basis as well as March 1, 1913 value in ascertaining taxable gain or loss.

For simplicity the 1924 act provided that the basis for determining *gain* or *loss* on property acquired prior to March 1, 1913, shall be the cost or other basis of such property, or its March 1, 1913, value, whichever is higher. This act also added the requirement that in determining fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of its assets as of that date. However, beginning with the Revenue Act of 1934 the use of March 1, 1913 value is inapplicable in determining *losses*. It was the view of Congress that the provision permitted amounts to be treated as losses, when, in fact, no loss had been sustained.

Part V—Changes To Effectuate FCC Policy

1. Gain from sale or exchange to effectuate polices of FCC (*sec. 1071*)

This is a relief provision, originally enacted in the Revenue Act of 1943. It permits the deferral of gain from the sale of radio broadcasting or telecasting properties, including stock in a corporation owning such properties, if the transaction is certified by the FCC as necessary or appropriate to effectuate its policy (relating to ownership and control of broadcasting stations). The taxpayer can elect to treat the sale as an "involuntary conversion" and nontaxable, if the proceeds are used to purchase similar property (including stock in a corporation owning such property). In addition, a second and independent election is granted whereby the gain, in whole or in part, will not be recognized to the extent that the basis of the remaining depreciable property is reduced.

By the Technical Amendments Act of 1958, the section was made applicable solely to sales or exchanges of property to effectuate "a change in the policy of, or the adoption of a new policy by, the Commission." This was deemed necessary as purchasers of "excess" facilities were obtaining certification from the FCC that a subsequent disposition of an older facility was necessary or appropriate. Thus, deferment of gain was resulting from transactions that were, in effect, voluntary undertakings.

Part VI—Exchanges in Obedience to SEC Orders

1. Nonrecognition of gain or loss on exchanges or distributions in obedience to orders of SEC—basis (secs. 1081–1082)

These sections, which first appeared in the Revenue Act of 1938, are "special" nonrecognition of gain or loss and related basis provisions; they deal with exchanges or distributions *ordered* by the SEC in furtherance of the policies of the Public Utility Holding Company Act of 1935. Congress noted its directive to the Commission to effect the simplification and geographical integration of public utility holding company systems, which required many properties to be regrouped, corporations to be completely or partially liquidated, and stock or securities shifted. Due to the compulsory nature of such transactions, Congress provided that any gain or loss resulting therefrom should be postponed until a voluntary realization occurred.

Such transactions were described briefly in Senate Report 1567, accompanying the 1938 act, as:

> (1) cases in which a holder of stock or securities in a registered holding company or a majority-owned subsidiary disposes of his stock or securities by transferring them to such company or to another registered holding company or majority-owned subsidiary which is in the same holding company system in exchange for other stock or securities; (2) the disposition of property by a member of a holding company system in exchange for other property; (3) distributions of stock or securities by registered holding companies or majority-owned subsidiaries to their shareholders; and (4) a disposition of property in a transaction solely between members of a limited class of closely related [system group] corporations.
>
> In none of the above transactions, except (4), is cash or other "nonexempt" property receivable without the recognition of gain.

Compensating provisions designed to prevent a stepped-up basis were also enacted. In general, under (1) and (2) above, the "basis" of the property disposed of becomes the "basis" of the property received. When gain is recognized, because of the receipt of nonexempt property, an appropriate adjustment to basis is required. Under (3) an apportionment of "basis" is required to be made between the property received and the stock with respect to which the distribution was made. Under (4) the "basis" of the property in the hands of the transferor continues with the property after the transfer.

The Revenue Act of 1942 added clarifying amendments and extended the nonrecognition provisions to other situations which were made necessary by compliance with the Commission's orders. Thus, where a direct exchange of properties under (2) is not feasible, other methods are permitted, such as the sale of assets with the application of the proceeds to the purchase of other property, or the retirement or cancellation of stock or securities. Essentially the statute, as thus amended, permits the nonrecognition of *gain* alone where there is a transfer of property in exchange for any kind of property, including money, if certain conditions are met. In addition, adjustment to basis is required. Any loss is governed by other provisions of the code.

The 1954 Code added a special rule to (3) permitting, under certain conditions, the nonrecognition of gain when the distribution consists of "rights" to acquire common stock in another corporation, and the distributing corporation disposes of all of its common stock in such other corporation prior to January 1, 1958.

Part VII—Wash Sales of Stock or Securities

1. Loss from wash sales of stock or securities (*sec. 1091*)

This provision originated in the Revenue Act of 1921 to prevent tax avoidance; it has been continued since 1932 without substantial change. In general, it denies losses from sales of stock or securities if within 30 days, either before or after such sale, the taxpayer acquires, either by purchase or through a taxable exchange, substantially identical property. The section does not apply to losses of an individual incurred in his trade or business, nor to losses of a corporation that are incurred by it as a dealer in stocks or securities.

The 1924 act corrected an oversight by requiring an adjustment to basis to reflect any difference between the repurchase price and the sales price. It also extended repurchase to include a contract or option to acquire substantially identical property.

As the number of shares repurchased or sold often vary, and as the transactions involve different dates and sales prices, the Revenue Act of 1932 authorized the Secretary of Treasury to issue regulations governing the required allocations. Prior law had assumed that such identification or allocation was unnecessary or, if necessary, could readily be made. In order to prevent a conflict in the basis provisions, this act also added an amendment to make it clear that it applied only to "acquisitions" of substantially identical stock or securities by purchase or through a taxable exchange on which the gain or loss was fully recognized.

Part VIII—Distributions Pursuant to Bank Holding Company Act of 1956

1. Distributions pursuant to Bank Holding Company Act of 1956 (*secs. 1101–1103*)

This is a relief provision relating to divestment of property by corporations that would have been "qualified" bank holding corporations by reason of owning "prohibited property" on May 15, 1955, if the Bank Holding Company Act of 1956 had been in effect on that date; or by reason of having acquired "prohibited property" subsequent to May 15, 1955, in certain tax-free transactions, including a distribution from a qualified bank holding corporation. In general, a "bank holding company" means a corporation that directly or indirectly owns or controls 25 percent or more of the voting shares of each of two or more banks or of a bank holding company; or it controls the election of the majority of the directors of each of two or more banks; or it is a successor in interest of another bank holding company. "Prohibited property" consists of stock or assets of nonbanking businesses, exclusive of cash, Government bonds, or certain short-term obligations.

It was the intention of Congress to remove from a bank holding company the danger of misusing the resources of a controlled bank for the advantage of a nonbanking business. Accordingly, "qualified" bank holding corporations were required to choose between two mutually exclusive alternatives—(*a*) to remain a bank holding company and to dispose of its "prohibited property," or (*b*) to retain such other property and to dispose of its "banking assets."

Due to the compulsory nature of this requirement Congress amended the 1954 Code to permit, under certain conditions, nonrecognition of gain to the shareholders of qualified bank holding corporations.

(1) A bank holding corporation is permitted to distribute "prohibited property" tax free to a shareholder or security holder (*a*) without the surrender of stock, (*b*) in exchange for its preferred stock, or (*c*) in exchange for its securities; or

(2) It can transfer such "prohibited property" to a wholly owned subsidiary, created for that purpose, and distribute the stock and securities received on such exchange tax free to its shareholders: (*a*) common stock of the subsidiary can be distributed without the surrender of stock or it can be exchanged for its common stock; (*b*) preferred stock or common stock of the subsidiary can be exchanged for its preferred stock; or (*c*) securities, preferred stock, or common stock of the subsidiary can be exchanged for its securities.

Any preferred stock or securities received by the shareholders under (1) or (2) in exchange for preferred stock or securities must have substantially the same terms as the preferred stock or securities exchanged. Whether or not a distribution is pro rata with respect to all of the shareholders is immaterial. In addition, the Federal Reserve Board must first certify that divestment of such property is necessary or appropriate to effectuate the policies of the Bank Holding Company Act of 1956, and must later certify that the divestment was accomplished within the statutory period permitted. Such transactions will not be tax free if final certification is not obtained, or if the distribution is part of a plan having as one of its principal purposes the distribution of earnings and profits.

If a bank holding corporation chooses to divest itself of its "banking assets," similar tax-free distributions are permitted with comparable restrictions.

SUBCHAPTER P. CAPITAL GAINS AND LOSSES

Part I—Treatment of Capital Gains

1. Alternative tax (sec. 1201)

This section, which provides for the alternative tax limited to 25 percent on long-term capital gains, goes back to 1921. At that time Congress fixed an alternative rate for individuals at 12½ percent of the net gain. The reason given was that sales of farms, mineral properties, and other capital assets had been seriously retarded by the fact that gains and profits earned over a series of years were, under then existing law, taxed as a lump sum in a single year when realized. Many such sales were believed to have been blocked by this feature of the law.

The 12½-percent rate was a compromise between the House version, which limited the tax to 15 percent, and the Senate version, which took into account only 40 percent of the net long-term gain.

The alternative rate for corporations was first provided in 1942, at which time the rate on ordinary income of corporations was increased to 45 percent. The alternative rate for corporations has always been applied to the whole of long-term capital gain rather than to the percentage of such gain taken into account, as in the case of individuals.

2. Deduction for capital gains (*sec. 1202*)

This section, which currently provides that only 50 percent of net long-term capital gain will be taken into account for tax purposes in the case of individuals, goes back to 1934. At that time the approach of taking less than the full gain into account, in order to reduce the effective tax rate, was first written into the law. The 1934 act provided that all of capital gain realized in 1 year or less must be taken into account but that smaller percentages of gain might be counted on older assets—ranging down to 30 percent in the case of capital assets held for more than 10 years.

Experience with this so-called "step scale plan" during the 1930's indicated that it encouraged taxpayers to hold property in order to take advantage of the next available stepdown in percentage of gain taken into account. The present 50-percent inclusion of long-term capital gain for tax purposes goes back to 1942.

Part II—Treatment of Capital Losses

1. Limitation on capital losses (*sec. 1211*)

The idea of some limitation on the deductibility of capital losses goes back to the 1921 act, which first imposed the alternative rate on net long-term capital gains. At that time losses were allowed to reduce tax by not more than 12½ percent, the same as the maximum rate applied to gains. This was considered to provide parallel treatment for both gain and loss, in spite of the fact that gains and losses were frequently realized by different individuals. The limitation put on corporations—that capital losses might be offset only against capital gains but not ordinary income—goes back to 1934. At that time the House sought to impose the general rule that no offset of capital loss against ordinary income should be permitted for any taxpayer. The purpose was to protect the revenue in view of the heavy decline in security prices following 1929. The Senate considered this rule too harsh in the case of small investors and accordingly provided for a limited allowance of capital loss—up to $2,000 against ordinary income—for individuals.

Earlier, in the 1932 act, a limit had been put on the deduction of losses from the sale of stocks and bonds held for less than 2 years. Under the then current definition these did not fall within the category of capital assets.

It should be noted that under the 1934 act, which provided for the scaling down of long-term capital gains, losses on securities held only for a brief period could in some cases offset more than three times the amount of gain realized from sale of other securities.

The $2,000 offset of net capital loss against ordinary income for individuals was repealed in 1939, but at the same time a limited carryover of unused loss to the succeeding taxable year was permitted. In 1942 the statute assumed its present form; this allows individuals a $1,000 offset against ordinary income plus a 5-year carryforward of any unused loss to be applied against capital gains of later years plus $1,000 of ordinary income each year.

2. Capital loss carryover (*sec. 1212*)

In present form this section goes back to 1942; but limited provision for capital loss carryover had been made previously. The 5-year period now permitted was said to minimize the likelihood of complete disallowance of loss and to be as long a period as was administratively feasible. The 1932 act, which first imposed a loss limitation, provided for a carryover of unused loss (not in excess of the taxpayer's net income) for 1 succeeding taxable year. The 1934 act provided for no loss carryover. The 1938 act reintroduced the 1-year carryover for individuals but not for corporations. The present 5-year carryforward, as already noted, emerged in 1942 and has remained unchanged since that time.

Part III—General Rules for Determining Capital Gains and Losses

1. Capital asset defined (*sec. 1221*)

This section, which defines the scope of the special provisions applicable to capital gains and losses, has an extensive history. The act of 1864 included within net income subject to tax "any profits realized on sales of real estate purchased within the taxable year." Gains from real estate held for more than 1 year were presumably exempt from tax. In 1867 this rule was amended to include in taxable income profits from real estate purchased within the 2 preceding years.

The 1913 income tax law included in the definition of net income—"gains, profits, and income derived from * * * sales, or dealings in property whether real or personal * * *." Under this provision the Treasury treated all gains from the sale of property exactly as other items of income, imposing upon them the full normal and surtax rates.

A formal definition of capital assets first appeared in the 1921 act. At that time the definition included property acquired and held by the taxpayer for profit or investment for more than 2 years, but did not include—

> property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

The present definition has gradually evolved since that time.

The form of the capital asset definition, namely, all property except certain designated exclusions, is already apparent in the 1921 act. The 1924 act added to the exclusions "property held by the taxpayer primarily for sale in the course of his trade or business." This amendment was made to remove doubt concerning the application of the prior definition.

The 1921 act also excluded from the definition of capital assets property held for the personal use or consumption of the taxpayer. This was removed in 1924 in order to permit taxpayers selling residential property to elect to be taxed under the capital gains sections.

The 1934 act removed from the definition of capital assets any reference to the length of time property had been held. Previously property held only 2 years or more had qualified. This change was necessary because of the varying percentages of inclusion that were provided under the 1934 act.

The exclusion from the category "capital assets" of property used in the trade or business which is subject to an allowance for depreciation was added in 1938. The purpose of this change was to allow losses realized on the sale or exchange of such depreciable property to be deducted in full from ordinary income. It was held at the time that corporations were deterred from disposing of partially obsolescent property because of the capital loss limitations.

The exclusion from the capital asset definition of Government securities issued on a discount basis was made in 1941. This change was said to avoid troublesome allocations as between interest and capital gain or loss.

The exclusion of copyrights, literary, musical, or artistic compositions and similar property was added in 1950 with the purpose of giving greater certainty to the application of the tax provisions. Prior to that time an amateur author, composer, or artist could get capital gains treatment on the sale of this type of property, but a professional, who held such property for sale in the ordinary course of his trade or business, realized ordinary income from the same type of sale.

2. Other terms relating to capital gains and losses (sec. 1222)

This section, which defines various terms employed in the application of the capital gain and loss provisions, has gradually evolved since 1921. The Revenue Act of that year first introduced the terms "capital gain" and "capital loss" but limited these terms to designated property held more than 2 years. The definitions of "short-term" and "long-term" capital gain and loss first appeared in the 1938 act. The distinction was said to have been made for the purpose of separating, in a practical way, speculative transactions from investment transactions. Short-term capital gain and loss were at that time defined as derived from property held not more than 18 months, whereas long-term gain or loss resulted from property held more than 18 months.

The 1938 act modified the 1934 system of taking into account varying percentages of capital gain and loss accrued over different periods of time. Two-thirds of long-term gain or loss was counted if the property had been held more than 18 months but not more than 2 years; 50 percent of gain or loss was counted if the property had been held longer than 2 years.

In 1951 the definitions were changed to eliminate what was known as the "two for one" offset. Prior to that time, $1 of short-term loss, which was wholly taken into account for tax purposes, could offset $2 of long-term gain, which was only 50 percent taken into account. As a result, taxpayers with both gain and loss were taxed or credited not upon actual amounts of net gain or loss but upon fictitious balances. The 1951 act corrected this by providing that all gains and losses must be taken into account at 100 percent of face value; but that any excess—representing net long-term capital gain—would be scaled down before application of the tax rate.

3. Holding period of property (sec. 1223)

This section, which provides various rules for determining the holding period of property falling within the scope of the capital gain and loss provisions, has been evolving during most of the period these provisions have been in effect. The 1926 act first provided for adding together or "tacking on" the holding period of property received in an exchange and any prior holding period on this property—provided it has the same basis in the taxpayer's hands as in the hands of the original holder. This provision was adopted in order to remove uncertainty in the case of property received in a nontaxable reorganization. The statute merely incorporated prior Treasury regulations on the subject.

The rules pertaining to the holding period of stock acquired by the exercise of rights go back to 1942. Prior to that time a rule had been developed by the courts that shares acquired through rights consisted in part of assets dating back to the original acquisition of the stock and in part of short-term assets dating only from the exercise of the rights. This rule in practice caused numerous administrative difficulties and became unworkable where a series of stock rights were issued. To avoid these difficulties all stock acquired by rights was dated only from the time the rights were exercised.

Subsection (7) dealing with the holding period of a residence, acquired following the sale of another residence on which no gain was recognized, dates from 1951. This provision was added to conform to the rule concerning postponement of tax on gain from the sale of a residence that was legislated in that year.

Part IV—Special Rules for Determining Capital Gains and Losses

1. *Property used in the trade or business and involuntary conversion (sec. 1231)*

This section, which provides long-term capital gains treatment combined with ordinary loss treatment for property falling within the scope of the section, goes back to 1942. Prior to that time the property in question, not being within the category of capital assets, resulted in either ordinary gain or ordinary loss when sold. There was, at the time, a feeling that this rule impeded the sale of property and hampered the conversion of facilities to war production.

The House would have solved this problem by providing capital gain and capital loss treatment—in other words, by expanding the definition of capital assets to include property used in the trade or business and involuntary conversions. The Senate preferred the other rule of capital gain and ordinary loss; this rule was enacted and has carried down to the present time.

Timber was brought under this section in 1943 and livestock held by the taxpayer for draft, breeding, or dairy purposes for 12 months or more was specifically brought under the section in 1951. Prior to that latter date some uncertainty had existed about the taxation of livestock. Rulings of the Treasury Department issued in 1944 and 1945 held that capital gains treatment was applicable only in case of unusual sales, such as those which reduced the normal size of a herd or those resulting from a change of breed or other special circumstances; capital gains treatment would not apply to a customary sale by a farmer of old or disabled animals culled from the breeding herd.

In 1949 a circuit court of appeals decided in the *Albright* case that animals used for breeding purposes constituted property within the meaning of this section. In spite of this decision Treasury adhered to its earlier rulings, which were more restrictive than the court decision. Congress sought to clarify this situation by enacting a new section in 1950. This was limited to cattle and was rejected in conference as not stating a clear policy with respect to livestock generally.

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2. Bonds and other evidences of indebtedness (*sec. 1232*)

This section, which provides generally for the proration of gain resulting from the retirement of bonds as between ordinary income and capital gain, was enacted in 1954 to remove uncertainty in the prior law. Any gain attributable to the original issue discount (if more than a specified amount) will be taxed as ordinary income and any residual gain will be capital gain. Earlier rulings had failed to split the gain and had produced an erratic classification as between ordinary and capital gain.

3. Gains and losses from short sales (*sec. 1233*)

This section was enacted in 1950; it was designed to deal with a tax avoidance problem in cases where individuals had previously converted short-term gain into long-term gain in order to take advantage of the lower tax rate; they had done this by selling "short" certain securities on which they had accrued but unrealized appreciation. The section provides that any gain from closing a short sale will be regarded as short-term capital gain if substantially identical property has been sold; and that any holding period on this property will be cut off by the short sale. In 1950 the section was rewritten to include certain options to sell or "puts" which could be used in essentially the same way as short sales to insure an unrealized gain. Options to sell acquired simultaneously with the original investment in identical property do not fall within this section—since 1954.

4. Sale or exchange of patents (*sec. 1235*)

This section, which provides that proceeds from the sale of a patent by an inventor will be treated as long-term capital gain, was added in 1954; it was designed to clear up uncertainty and to provide an incentive for invention. Under earlier rulings and court cases, an amateur inventor might receive capital gains treatment on such a sale but a professional was charged ordinary income tax rates. This distinction was considered both arbitrary and confusing. Under earlier court decisions the grant of an exclusive license to a patent was considered to be a sale for tax purposes. This rule was not changed by the 1954 legislation.

5. Dealers in securities (*sec. 1236*)

This section, which provides that dealers can get capital gains treatment only on securities which are clearly identified and segregated as held for investment, goes back to 1951. Prior to that time dealers were free to shift securities between their inventory and their investment accounts. The result was that they got ordinary loss treatment on any sales at a loss and capital gains treatment on any sales at a profit. This result is avoided by the requirement that their investment account and their inventory must be kept separate.

6. Real property subdivided for sale (*sec. 1237*)

This section, which permits sale of the first five lots in a subdivision to be accorded long-term capital gains treatment—provided the taxpayer is not in the real estate business—was added in 1954. The reason was that an individual who had acquired real estate for investment purposes frequently could only dispose of it advantageously by subdividing; in this case he was liable to be treated as a real estate dealer and taxed on his proceeds as ordinary income. Congress felt that in limited cases subdivision was merely incidental to disposition of the real estate investment and hence that capital gains treatment should not be denied.

7. *Amortization in excess of depreciation* (*sec. 1238*)

This section, which provides that a portion of the gain from the sale of property which has been subject to accelerated amortization shall be ordinary income rather than capital gain, was added by the Revenue Act of 1950 which reestablished the emergency amortization provisions. The object was to avoid giving a bonus to owners of property who had already benefited by the rapid amortization provisions.

8. *Gain from sale of certain property between spouses or between an individual and a controlled corporation* (*sec. 1239*)

This section, which provides that any gain on such sales shall be ordinary income, was added in 1951 to deal with a tax avoidance situation. Under earlier rules taxpayers could in such sales obtain a stepped-up basis for depreciation by the payment of a capital gains tax.

9. *Taxability to employee of termination payments* (*sec. 1240*)

This section, added in 1951, provides that payments in commutation of rights to receive a portion of future profits or receipts from a business shall be taxed to an employee as capital gains, if received on termination of his employment under certain restricted conditions. It was felt at the time that to treat such payments as ordinary income was unduly harsh; also that employees should not be forced by tax considerations to have their retirement incomes dependent on a business after they had severed their connections with it.

10. *Cancellation of lease or distributor's agreement* (*sec. 1241*)

This section, which provides that any proceeds from such a cancellation shall be considered as received from a sale or exchange, was added by the 1954 Code. It was designed to give statutory sanction to prior court decisions on the subject. No substantive change in existing law was intended.

11. *Losses on small business investment company stock* (*sec. 1242*)

This provision was added in 1958, at which time these investment companies were first established. The section treats any loss from such stock as an ordinary loss—thereby removing it from the capital loss limitations. Similarly, section 1243 makes the loss on any convertible debentures issued by a small investment company an ordinary loss. Finally, section 1244 extends this same treatment to losses on stock of specially defined small business corporations, subject to certain limitations. All three of these provisions were designed to stimulate the flow of equity capital through appropriately defined small business companies.

SUBCHAPTER R. ELECTION OF CERTAIN PARTNERSHIPS AND PROPRIETORSHIPS AS TO TAXABLE STATUS

1. *Unincorporated business enterprises electing to be taxed as domestic corporations (sec. 1361)*

This provision was included in the Senate bill for the 1954 Code, along with a companion provision permitting certain corporations to be taxed as partnerships. The purpose of both provisions was to eliminate the effect of the Federal tax laws on the form of organization adopted by certain small businesses. Congress enacted the provision permitting sole proprietorships and partnerships to be taxed as corporations. The companion provision failed of enactment in 1954, apparently because of revenue considerations.

The concept introduced by this provision was an extension of the principle that Federal taxation should have a "neutral" effect in the making of business decisions. Thus, the aim was to equalize the tax treatment of partnerships and corporations engaged in similar enterprises.

To qualify for the election, the business enterprise must be owned by one individual or a partnership of not more than 50 members and its income must be substantially derived from capital, trading, or brokerage. If the election is made, the enterprise is taxed as a domestic corporation. However, there is excluded from the corporate tax any item which qualifies as personal holding company income, which is taxed to the individual proprietor or partners as though an election had not been made.

The owners of the enterprise are taxed as shareholders on distributions other than personal holding company income. They are not, however, considered employees with respect to pension and profit-sharing trusts and other similar benefits available to employee shareholders of a corporation.

The election must be made within 60 days after the end of the taxable year by all the individuals who had an interest in the enterprise during that year. Under "temporary rules" a "tentative" election is made by filing a return which can be "perfected" by filing an amended return to be prepared in accordance with the final regulations.

In 1958, the House voted to repeal section 1361 for the reason that the provision had proved difficult to apply in actual practice; this was chiefly because of the complexities which can arise in such problems as how to treat undistributed earnings and profits when the enterprise is no longer taxed as a corporation. However, the Senate believed that many of the problems could be clarified by regulations. It noted that the provision is important to small business and is likely to be extensively used when taxpayers can be sure of the tax consequences of the election.

Section 63 of the Technical Amendments Act of 1958 provides a statutory substitute for the temporary rules to insure that an election will not be binding on the taxpayer before final regulations are issued. It expressly provides that a valid election may be subsequently revoked at any time after enactment of the section and during a period ending 3 months after final regulations are published. The period for assessment or refund is extended for 1 year after the time allowed for revocation, or for 1 year after an actual revocation if that occurred earlier.

SUBCHAPTER S. ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS AS TO TAXABLE STATUS

1. Qualifying as a small business corporation (sec. 1371)

This subchapter, enacted in 1958, complements subchapter R which was enacted in 1954 to permit certain unincorporated enterprises to be taxed as corporations. At the time subchapter R was under consideration, the Senate also approved a provision to permit certain corporations to be taxed as partnerships but Congress failed to enact the measure. The provisions of subchapter S differ from the 1954 Senate provisions by treating an electing corporation under the general corporate rules with specified exceptions.

The purpose here, as in the case of subchapter R, was to permit greater flexibility in selecting the form of business organization by minimizing differences in tax consequences. In addition, it was believed that the provision would be of substantial aid to small business. In this context it may be viewed as a "relief" provision primarily beneficial (1) to those shareholders of closely held corporations who have marginal tax rates below the 52-percent corporate rate and (2) to those shareholders of new corporations which operate at a loss for a number of years.

The special tax treatment under subchapter S is available after December 31, 1957, to a domestic corporation with less than 11 shareholders (individuals or estates but excluding nonresident aliens), having one class of stock outstanding, and not eligible to file a consolidated return. The test of "small" is based on the number of shareholders rather than assets or income. The restriction to one class of stock arises from the administrative difficulties which might be encountered if corporations with more than one class were included.

The limitation on the number of shareholders had been interpreted by the Internal Revenue Service as requiring that shares held by a husband and wife as coowners were to be considered as owned by separate shareholders. To contravene this interpretation, Congress added subsection (c) to this section by Public Law 86–376 in 1959. It expressly provides that, after December 31, 1959, husband and wife are to be treated as one shareholder if their shares are held as community property, or tenants in common, or tenants by the entirety, or joint tenants.

2. Election by small business corporation (sec. 1372)

This section deals with (1) the time and procedure for making the election, (2) the conditions under which it is terminated, and (3) its tax effect. To make a valid election all the shareholders must consent to the election under subchapter S, which must be made during the first month of the taxable year or the preceding month. Once made, the election is effective until revoked or terminated. The corporation's status as of the date of the first election will not affect its right to make the election so long as the requirements of section 1371 are met. Thus a corporation in the process of partial or complete liquidation may, if otherwise qualified, make the election under 1372 and this fact will not invalidate the election.

The practical effect of the "termination" provisions of this section is to add additional requirements to those contained in section 1371. Thus, an election once made will be terminated in the taxable year in which any of the following occur: (1) A new shareholder fails to consent to the election; (2) more than 20 percent of the corporation's gross receipts are derived from "passive" income such as interest, dividends, etc.; (3) more than 80 percent of receipts are from foreign sources; or (4) the corporation ceases to meet the requirements of section 1371.

If the election is terminated, the corporation is ineligible for subchapter S treatment for a 5-year period except with the consent of the Secretary or his delegate. This limitation was included in order to prevent tax avoidance by switching back and forth between subchapters C and S.

If the election is made, the shareholders, and not the corporation, are taxed on the corporation's income, whether distributed or not. The rules of subchapter C apply to the corporation and its shareholders to the extent they are not inconsistent with subchapter S. Thus, employee shareholders would be eligible for so-called fringe benefits, such as pension and profit-sharing plans. Or, the corporation may have a tax year different from that of its principal shareholders. In such case it is possible for the latter to postpone or shift income between 2 taxable years. These benefits are not available to individuals operating as a partnership. Accordingly, H.R. 9003 (86th Cong., 2d sess.) seeks to equalize the tax treatment of partners and subchapter S shareholders by denying these benefits to the latter.

3. Undistributed taxable income (*sec. 1373*)

Under this section the shareholder is required to include his pro rata share of the corporation's undistributed taxable income in his gross income. Thus, in addition to including *actual* distributions during the year out of current earnings and profits, the shareholder must alsc include his pro rata share of the corporation's undistributed taxable income and not its earnings and profits. This "*constructive*" dividend is taken into account in the shareholder's taxable year in which the taxable year of the corporation ends. It is considered to have been received on the last day of the corporation's taxable year by those who are shareholders on that date. Thus, the rule of this section is to treat the shareholders as though they were the direct recipients of the undistributed taxable income.

Since the income of an electing small business corporation is taxed to its shareholders and not to the corporation, it was necessary to provide special rules for computing its taxable income and its undistributed taxable income. Accordingly, taxable income is determined without regard to the net operating loss deduction and most of the various special corporation deductions in subchapter B. The taxable income reduced by the amount of *money* distributed as dividends during the taxable year out of current earnings and profits equals the undistributed taxable income. The latter is not reduced by distributions deemed to be out of accumulated earnings and profits or by distributions in kind. These special rules were adopted to correlate subchapter S with C and thereby prevent unintended tax benefits.

4. Corporation net operating loss allowed to shareholders (*sec. 1374*)

The "pass-through" of the corporation's net operating loss to its shareholders represents one of the instances wherein a shareholder is treated as a partner. The loss is computed on a daily basis in the hands of the corporation, without the deduction for dividends received, and is deemed to be distributed pro rata to the shareholders. In the hands of the shareholder it is treated as a business loss in the taxable year of the shareholder in which the taxable year of the corportation ends.

The amount of loss available to the shareholder may not exceed the adjusted basis of his stock and of any debt owed him by the corporation. To the extent the deduction is allowable to him the shareholder must reduce the basis of his investment in the corporation.

With the enactment of subchapter S, a new provision was also added to section 172 of the 1954 Code to provide that any loss available to a shareholder under subchapter S may not be used by the corporation as a carryback or carryover.

In 1959, section 1374 was amended by Public Law 86–376 to provide that the loss will be available if a shareholder dies before the end of the corporation's taxable year. In the absence of this amendment the pro rata share of the deceased shareholder's loss was not available to anyone.

5. Special rules applicable to distributions of electing small business corporations (*sec. 1375*)

Under this section conduit treatment is accorded long-term capital gains. Other types of corporate income lose their characteristics in the hands of the shareholder. For example, tax-exempt interest income of the corporation is treated as taxable income to the shareholder.

The special pass-through rule applies only to distributions (actual and constructive) out of earnings and profits of the taxable year, and may not exceed the taxable income of the corporation for such year. If several distributions are made during the year, the capital gains must be allocated ratably to the several distributions. In computing the amount of dividends which represent long-term capital gains to the shareholder, the taxable year of the corporation rather than of the shareholder is used. The reason for this rule is to prevent a shareholder from allocating all of his capital gains in one of his taxable years which overlap the corporation's taxable year.

The possibility of a temporary election under S, for the purpose of taking advantage of the capital gains provisions, has been recognized by H.R. 9003 (86th Cong., 2d sess.) which would deny the capital gains pass-through for a 3-year period.

Another special rule to harmonize the basic concept of subchapter S with C is the provision which denies the dividends received credit and exclusion. These benefits were adopted to minimize the "double" tax on dividend income received by shareholders of ordinary corporations. To grant the credit and exclusion to an S shareholder would mean that some income would escape taxation altogether.

Another provision of this section is designed to prevent tax avoidance which could arise from splitting income among members of a family group who are shareholders of the S corporation. This rule provides that the Secretary, or his delegate, may apportion distributions (actual and constructive) to a family group in order to reflect the value of services rendered to the corporation by such shareholders.

6. Adjustments to basis of stock and indebtedness (*sec. 1376*)

The rules of this section require that adjustments be made to the basis of the shareholder's stock, and to the basis of any S corporation indebtedness to him, when there has been a constructive dividend under section 1373 or a net operating loss under section 1374. This rule is based on the assumption that the constructive dividend was actually received and then reinvested in the S corporation.

The stock basis is reduced, but not below zero, by a net operating loss attributable to such stock for the taxable year. The net operating loss is first applied to a reduction of the basis of the shareholder's stock and then any loss in excess of the stock basis reduces the basis of the corporation's indebtedness to the shareholder.

7. Special rules applicable to earnings and profits of a subchapter S corporation (sec. 1377)

This section introduces three special earnings and profits concepts which are applicable to an S corporation.

1. The accumulated earnings and profits are reduced by the amount of undistributed taxable income included in shareholders' gross income. This rule was adopted to avoid double taxation which would otherwise occur.

2. Since the S corporation pays no tax, and in order to insure that the corporation's taxable income is taxable to its shareholders, this section provides that the current earnings and profits shall not be reduced by any amount which is not allowable in computing taxable income. This rule is necessary in order that a corporation may not decrease its current earnings and profits by expenditures and losses which do not qualify as deductions for Federal tax purposes, and thereby defeat the general purpose of taxing the corporation's income as dividends to the shareholders.

3. To avoid a double benefit to shareholders arising from the net operating loss pass-through, a special rule provides that the current earnings and profits or the accumulated earnings and profits are not affected by any item of gross income or any deduction taken into account in determining the amount of any net operating loss. In the absence of such a rule, the earnings and profits would be reduced by approximately the amount by which the corporation's deductions exceeded its gross income. A tax-free distribution could then be made.

SUBTITLE C—EMPLOYMENT TAXES

Chapter 21—Federal Insurance Contributions Act

SUBCHAPTER A. TAX ON EMPLOYEES

1. Rate of tax on employees and employers (secs. 3101 and 3111)

This chapter was originally enacted in 1935 as title VIII of the Social Security Act. With adoption of the Internal Revenue Code of 1939, the taxing provisions of title VIII were included in subchapter A of chapter 9 of that code.

The schedule of tax rates on employees in section 3101 is the same as the schedule for the employer's tax in section 3111. Both schedules have undergone many simultaneous changes since they were first enacted. The 3-percent rate, which became effective for calendar year 1960, was originally scheduled to become effective for calendar years beginning with 1949. As originally enacted, the rate of tax applicable to wages was the rate prevailing as of the time of performance of the services. Congress found that this provision unnecessarily complicated the making of returns and the collection of taxes in later years when the rate had been increased. Thus, wages paid and received in one year for services performed in a prior year when a different tax rate was in effect meant that the tax return must provide for computations at different rates. In addition, a subsequent audit of the return would require a determination not only of the time when the wages were paid and received but also of the year when the services were performed. To avoid this complication, sections 601 and 604 of the Social Security Act Amendments of 1939 provided that the rate in effect when the wages were paid and received would be used in computing the tax, without reference to the year in which the services were performed.

2. Deduction of tax from wages (*sec. 3102*)

The first sentence of this section first appeared in section 802(a) of title VIII of the Social Security Act. The purpose was to insure the collection of the employee's tax by making the employer liable for it. The latter's liability attaches to the correct amount of tax, which he is required to deduct, regardless of the amount actually deducted. This liability attaches even though the employee's wages are paid in some form other than money. Neither is it necessary for the wages to be actually paid. Constructive payment renders the employer liable for the tax.

The last sentence of section 3102(a) was added by section 205A of the Social Security Amendments of 1954; this addition was intended to provide that the employer may deduct the tax from the pay of certain employees even though at the time he is not certain that this pay will meet the "wages" definition. This amendment was made to conform section 3102(a) with the amendment which was made to section 3121(a)(8)(B); this latter amendment provided, in part, that remuneration from agricultural labor would constitute wages if performed on 20 days or more during the year, irrespective of the amount of wages paid.

SUBCHAPTER B. TAX ON EMPLOYERS

1. Instrumentalities of the United States (*sec. 3112*)

This provision was first enacted by section 202(a) of the Social Security Act Amendments of 1950.

The exemptions from Federal taxation granted by various statutes to certain Federal instrumentalities, without specific reference to the FICA tax on employers, is made inoperative with respect to this tax. This is true regardless of whether the exemption was granted before or after enactment of this provision. Thus, this section made unnecessary the revision of prior laws granting such exemption, and served as a rule of construction in interpreting future legislation granting tax exemption to Federal instrumentalities. If the legislation granting the exemption does not specifically cite section 3111, the FICA tax will apply.

2. District of Columbia credit unions (*sec. 3113*)

This section removes the exemption granted these credit unions with respect to the employer's tax under section 3111. It was added by the Social Security Amendments of 1956. Prior to this amendment, credit unions deducted the employee tax under section 3101 but were not required to pay the employer tax under section 3111 because of the exemption from tax previously granted to them.

SUBCHAPTER C. GENERAL PROVISIONS

1. Definition of wages (*sec. 3121*(*a*))

As it appeared in section 811(a) of title VIII of the Social Security Act, the definition of wages was set forth in seven lines of type. The definition then included the present introductory clause with the provision that remuneration over $3,000 was excluded. Expansion of the definition from seven lines to two pages represents a refinement by the addition of a number of exceptions. In general, these additions have been concerned with (1) prevention of duplicate taxes; (2) incentives to employers to establish welfare plans for employees and their dependents; and (3) limitations on pay received from specified types of "employment."

With reference to paragraph (1), the current wage limitation of $4,800 became effective January 1, 1959 under Public Law 85–840. The original limitation of $3,000 was changed to $3,600 by the 1950 amendments and to $4,200 by the 1954 amendments. A clarifying amendment in 1950 provided that remuneration specifically excepted from wages shall be disregarded in computing the limitation.

The last sentence in paragraph (1) was added in 1950. Prior to this addition, the limitation on the amount of pay that constituted wages applied to amounts received by an employee from each separate employer. Thus, when during a calendar year an employee was hired by a new employer, the first $3,000 paid him by this new employer constituted wages regardless of the amount paid to the employee by the predecessor employer. The 1950 amendment prevented this duplicate taxation in certain cases by providing that, where an employer acquires substantially all the property used in a trade or business, the wages paid by the predecessor will be counted in applying the limitation.

As originally enacted by section 601 of the Social Security Act Amendments of 1939, paragraph (2) did not exclude payments for death benefits, if certain options were permitted during the employee's lifetime. Section 203 of the Social Security Amendments of 1950 expanded paragraph (2) to embrace such benefits within the exception. Also excluded were payments to or on behalf of an employee's dependents, provided they were made under a plan established for employees generally.

Paragraphs (3), (4), (5), and (7)–(10), inclusive, were added to the Internal Revenue Code by section 203 of the 1950 amendments; they became effective with respect to amounts paid after 1950.

Paragraph (6), pertaining to the payment of the employee's FICA or State unemployment taxes by the employer, was originally enacted by section 601 of the Social Security Act Amendments of 1939; it has remained substantially unchanged since then.

Paragraphs (2) through (6) exclude from wages any payments by the employer to or on behalf of the employee for "welfare" purposes.

By excepting these payments from "wages," and hence from the employment tax, Congress sought to eliminate any reluctance on the part of employers about establishing "welfare" plans because of the additional tax cost.

Paragraphs (7), (8), and (10) except from "wages" certain noncash payments and nominal cash payments to domestic, agricultural, and "home" workers, as well as payments for service not in the course of the employer's trade or business. These exceptions are based on considerations of administrative convenience. Cash remuneration for "service not in the course of the employer's trade or business," in paragraph (7), was not excepted from the definition of wages under the 1950 amendments, although the definition under "employment" excluded such service if the cash remuneration was under $50 and the employee was not "regularly employed." The 1954 amendments repealed the definition under "employment" and added subparagraph (C) to paragraph (7). The "days worked" test and the "regularly employed" concept were eliminated with respect to service as a domestic and service not in the course of the employer's trade or business. In addition, the application of the $50 limitation on pay during a calendar quarter is to be determined as of "time of payment." Prior to the 1954 amendment, the limitation was determined as of the time of performance of the service.

The 1950 amendments had excepted from the definition of wages noncash remuneration for agricultural labor; under the definition of employment, cash remuneration for agricultural labor amounting to less than $50 in a calendar quarter was excepted from "employment" if the employee was not "regularly employed." The concept of "regularly employed" meant that the employee must perform some work on each of 60 days during the quarter immediately preceded by a qualifying quarter.

The 1954 amendments eliminated these tests from the definition under "employment." In lieu thereof, there was included in paragraph (8) under the "wages" definition of "wages paid" test of $100. The concept of "regularly employed" was eliminated because Congress found the concept "complicated and difficult to apply." In addition, "wages paid" was figured on a calendar-year rather than a calendar-quarter basis, in order to reduce recordkeeping by farm operators.

The 1956 amendments added the alternative "days worked" test of 20 days. By increasing the "wages paid" test to $150 and providing the alternative test, Congress sought to exclude from coverage intermittent and part-time agricultural workers; and at the same time to extend coverage to a larger group of "customarily" employed agricultural workers who might otherwise be excluded under the "wages paid" test.

Paragraph (9), pertaining to standby employees who have reached retirement age, exempts the pay received by such employees if they performed no service during the period for which they are paid. Title VIII of the original Social Security Act exempted, under the definition of "employment," service rendered by employees who had reached age 65. The 1939 amendments repealed this provision. The 1950 amendments restored the exception under the definition of wages with limited application. The distinction in subparagraphs (A) and (B) between men and women was made to conform with the change made in retirement age for women by the 1956 amendments.

2. Definition of employment (sec. 3121(b))

The changes in the definition of employment from the time of enactment of the original Social Security Act reflect the extension of social security coverage to include additional occupational categories. As the coverage has expanded it has become necessary, primarily because of administrative feasibility, to exclude certain types of services within given occupational categories. This in turn has led to the adoption of separate definitions for some of these additional categories. For example, agricultural labor is defined in subsection 3121(g).

Out of these developments evolved a definition of employment differentiating between (1) service through 1954 and (2) service after 1954 if performed in the United States by a citizen or alien, and service outside the United States by an American citizen. With respect to the latter category (No. (2)), the definition excludes service in 17 different employments. There are embraced within these 17 exceptions some services which are subject to waiver of the exception provided certain conditions are met. For example, service by an employee for a religious organization is normally excluded but the organization may elect, under certain conditions, to have the social security system extended to service performed by its employees.

Except as provided in the exceptions, all service within the United States by an employee for the person employing him is covered employment irrespective of the residence or citizenship of either. This provision has been in the law from the beginning of the social security program. However, under the original act, service outside the United States was excluded. The 1939 amendments extended the definition of covered employment to include, under certain conditions, service outside the United States if performed on or in connection with an American vessel. The 1950 amendments further extended the definition to include service on or in connection with American aircraft, and also service performed by an American citizen outside the United States if performed for an American employer. The 1954 amendments extended the coverage to American citizens employed by American employers on vessels and aircraft of foreign registry.

The Social Security Act originally excepted from "employment" eight specified categories. These exceptions were "due to the difficulties of collecting the tax in the case of certain kinds of employment." The exceptions included: (1) agricultural labor, (2) domestic service in a private home, (3) casual labor not in the course of the employer's trade or business, (4) service by an individual age 65 or over, (5) certain service on or in connection with a non-American vessel, (6) employment by the U.S. Government or its instrumentality, (7) employment by a State or its instrumentality, and (8) employment by religious, charitable, and certaln other organizations.

The 1939 amendments eliminated the "age 65" provision and added to the list of exceptions the following categories: family employment, paragraph (3); service as an employee or employee representative covered by the railroad retirement system, paragraph (9); certain types of services for an exempt organization, paragraph (10)(A); service performed by a student in the employ of a school, college, or university (if paid less than $45 in a calendar quarter), paragraph (10)(B); service in the employ of a foreign government, paragraph (11); service in the employ of a foreign instrumentality on a basis of reciprocity, paragraph (12); certain services of a student nurse, paragraph (13); services in fishing and certain related activities (eliminated by the 1954 amendments); and service of newsboys under 18 years of age, paragraph (14)(A).

In addition to the foregoing exceptions, the 1939 amendments made some modifications in those exceptions which were retained. Thus, a definition of agricultural labor (sec. 3121(g)) was added; this had the effect of broadening the scope of the exception, thereby reducing the coverage. A disqualifying clause was added to the exception pertaining to religious, charitable, etc., organizations; this provided that the exception would not apply if a substantial part of the activities of the organizations consisted of carrying on propaganda or attempting to influence legislation. This clause is similar to the one in section 501 of the code (formerly sec. 101) pertaining to exempt organizations.

The exclusion of domestic service was extended in 1939 to include service in a college club, fraternity, or sorority. The exception relating to Federal instrumentalities was limited to those wholly owned by the United States or exempt from the FICA tax by other provisions of law. Partially owned instrumentalities of one or more States or political subdivisions were excepted if they were immune under the Federal Constitution from the FICA tax. The purpose to be achieved by these exceptions was to exclude those persons and organizations in which employment is part time or intermittent and earnings only nominal; consequently, payment of the tax is either inconsequential or would cause undue administrative problems.

Two changes were made in the definition of employment between 1939 and 1950. Section 4 of Public Law 291, 79th Congress, excepted from employment service performed for an international organization (par. 15). Subparagraph (B) of paragraph (14) relating to news vendors was added, over a Presidential veto in 1948, by Public Law 492, 80th Congress.

The Social Security Amendments of 1950, 1954, and 1956 greatly expanded coverage under the social security system. This was accomplished primarily by revising the existing exceptions and by adding to the definition of employment. This had the effect of including in covered employment any service which did not fall within the exceptions. For example, paragraph (1), relating to agricultural labor, originally excepted all such employment. The 1950 act included in the exceptions only service performed in connection with naval stores, the ginning of cotton, and other agricultural labor which did not meet the "wages paid" and "regularly employed" tests in a calendar quarter. The latter two categories were stricken from the exception in 1954 and service in connection with naval stores was eliminated in 1958. The present exceptions in paragraph (1) were added by the 1954 amendments and were further amended by the 1956 act, with reference to agricultural workers from any foreign country.

The 1950 amendments brought domestic service in a private home under social security coverage. This left as an exception in paragraph (2) domestic service performed by a student in a local college club, fraternity, or sorority.

Paragraph (4), relating to service aboard a vessel or aircraft of foreign registry, was amended by the 1954 act so as to exclude American citizens from the exception. Paragraph (5), relating to certain instrumentalities of the United States, is a companion provision to section 3112, which was enacted by the 1950 act. If the instrumentality is specifically excepted from the tax under section 3111, then service in the employ of such instrumentality is excepted from covered employment.

The basic provisions of paragraph (6), excepting certain services for the Federal Government or a Federal instrumentality, were added by the 1950 act. This amendment had the effect of extending coverage to certain Federal employees, such as temporary employees not subject to the civil service retirement system; it also extended coverage to certain civilian employees of some Federal instrumentalities, such as Federal credit unions, national farm-loan associations, etc. This coverage was broadened by the 1954 act and further extended by the 1956 act, which provided coverage for certain employees of the Federal Home Loan Bank and TVA. Coverage was also extended to service performed in the uniformed services of the United States by section 411(a) of the Serviceman's and Veterans' Survivor Benefit Act, Public Law 881, 84th Congress.

Paragraph (7), relating to employees of State and local government and instrumentalities thereof, was added in its present form by the 1950 act. While the effect of paragraph (7) is to exclude such employees (except those in covered transportation) from coverage, the 1950 act provided for coverage by agreement between the States and the Federal Government. At first the agreements were limited to employees not covered by a retirement system. The 1954 amendments removed this restriction, so that now most employees under State and local retirement systems can be covered, provided eligible employees vote for the coverage. Failure to cover State and local employees on a compulsory basis was due to a desire to avoid a constitutional question concerning the taxing of a State by the Federal Government. However, service in the employ of a State or political subdivision in connection with the operation of its public transportation system is covered on a compulsory basis with certain exceptions.

Service performed for religious and other organizations referred to in paragraph (8) was excepted from employment in the original Social Security Act. The 1950 act provided for voluntary coverage of the organization's employees by filing a waiver certificate. The provision for "permissible" coverage was due to a reluctance to tax a religious denomination because of the implications inherent in the separation of church and state concept.

The provisions of paragraph (16), relating to share-farming arrangements, were added by the 1956 amendments. Although the amendment was made effective with respect to service performed after 1954, it was intended to be merely declaratory of existing law. Individuals working under a share-farming arrangement were considered to be self-employed and hence not employees for old-age and survivors insurance purposes.

Service for certain Communist organizations is excluded by paragraph (17) which was added to the 1956 amendments by action of the conference committee. Prior to 1955 it was held by the Bureau of Old-Age and Survivors Insurance that services in the employ of the Communist Party were not covered. This position was overturned by an Appeals Council referee in 1956. Paragraph (17) was enacted in August 1956 to sustain the position of the Bureau.

3. Included and excluded service (*sec. 3121*(*c*))

This subsection, enacted by the 1939 amendments, relates to an employee who performs both included and excluded service for the same employer during a pay period. It establishes the so-called "50 percent rule"; this provides that if 50 percent or more of the service falls within the definition of employment, all service during the period will be subject to FICA. The "50 percent rule" was made inapplicable by the 1950 amendments to remuneration of less than $50 paid by certain exempt organizations.

4. Definition of employee (*sec. 3121*(*d*))

Beginning with the original Social Security Act, the term "employee" has included an officer of a corporation. In considering revisions of the Social Security Act in 1939, the House passed an amendment which provided for a definition broader than the common-law concepts of master and servant. Under this definition certain classes of salesmen would be employees. The Senate rejected the amendment and was upheld in conference.

Until 1948 the term "employee" had been subject to varying interpretations in administrative and judicial decisions. To resolve the conflict, the Supreme Court assumed jurisdiction and handed down its decisions in June 1947. As a result the Treasury Department prepared "proposed" regulations to reflect the "broad" interpretation and "tests" laid down by the Court. On June 14, 1948, Congress enacted, over a Presidential veto, House Joint Resolution 296, Public Law 642, which provided for the application of the usual common-law rules in determining who is an employee. This provision was to be applied retroactively under the Internal Revenue Code to February 10, 1939.

Section 205(a) of the Social Security Amendments of 1950 added paragraph (3) to the definition. Thus, the use of the usual common-law rules was retained, but service performed by an agent driver or commission driver engaged in certain distributing activities, by a full-time life insurance salesman, by a worker at home, and by a traveling or city salesman engaged in full-time solicitations from wholesalers, retailers, etc., specifically fell within the definition of an employee. The 1954 amendments removed the requirement that the services of workers at home must be subject to State licensing requirements.

5. Definition of agricultural labor (*sec. 3121*(*g*))

A definition of agricultural labor first appeared in the 1939 amendments. Its purpose was to exclude certain services not then exempt from social security coverage, "as such services are an integral part of farming operations." Agricultural labor was defined to include services performed in connection with specified products and operations, whether or not performed on a farm or in the employ of the owner or tenant of a farm; for example, services performed in connection with processing sap into maple sugar.

The 1950 amendments modified the definition by excluding certain operations, such as hatching of poultry, unless services in connection therewith were performed on a farm. A further modification excluded from the definition any service in connection with a horticultural or agricultural commodity in its manufactured state; for example, the pressing of raw apples into cider. The 1950 amendments also added subparagraph (5) to provide that agricultural labor includes service on a farm operated for profit even if not in the course of the employer's trade or business or in domestic service in a private home of the employer. The purpose for this addition was to eliminate the necessity for any separation of services performed within the residence of the farm operator from those services performed on any other part of the farm.

6. Definition of covered transportation service (sec. 3121(j))

Service by certain transit company workers in the employ of a State or political subdivision is excluded from the exception under section 3121(b). This exclusion has the effect of covering, on a compulsory basis, such employees under the social security provisions under certain conditions. The primary reason for the exclusion, which was enacted in the 1950 amendments, was to protect the coverage of employees of transit systems which were taken over by governmental units. If the company was taken over after 1950, the prior coverage would continue to be compulsory. However, in conformity with section 3121(b)(7) relating to State and local governments, coverage would not be compulsory if the governmental unit had a retirement system covering substantially all service in connection with the operation of the transit system.

7. Exemption of religious, charitable, and certain other organizations (sec. 3121(k))

The provision for waiver of exemption was first included in the 1950 amendments. In considering the status of exempt organizations with reference to the FICA tax, the House approved a provision whereby employees of these organizations would be covered on a compulsory basis, but payment by the organization of its share of the tax would be on a voluntary basis. As finally enacted, payment of tax by both the employee and the organizations described in section 501(c)(3) of the code was made voluntary. The election to be taxed is made by filing a waiver certificate expressing a desire to be covered and indicating that at least two-thirds of the organization's employees concur in the filing of the certificate.

The 1954 and 1956 amendments relaxed the rules relative to filing supplemental lists. Further changes were made by the 1958 amendments. Thus, the organization is now permitted to separate its employees into two groups—those in positions covered by a pension, retirement, or similar fund or system established by a State or political subdivision thereof, and those not in such positions. A waiver may then be filed with respect to either group, subject to approval by two-thirds or more of the employees in that particular group.

8. Agreement entered into by foreign corporations with respect to foreign subsidiaries (sec. 3121(l))

This provision, enacted in 1954, supplements the provision which extends coverage to American citizens employed outside the United States. Section 209 of the 1954 amendments provided that coverage on a voluntary basis would also extend to American citizens, if they were employed outside the United States by a foreign subsidiary of a domestic corporation. The purpose was to prevent gaps in coverage which would otherwise occur when citizens who ordinarily work within the United States work abroad for a subsidiary of an American corporation. Coverage is obtained by agreement between the domestic corporation and the Secretary of Treasury. As originally enacted, the domestic corporation must own 50 percent of the voting stock of the foreign subsidiary. The 1956 amendments reduced this ownership requirement to 20 percent.

9. Definition of crew leader (*sec. 3121*(*o*))

This provision was enacted by the 1956 amendments to meet a problem arising in connection with the employment of farmworkers during harvesting season. The identity of the employer of such crews of agricultural workers (as between the crew leader and the farm operator) had to be determined by examining the employment relationship in the light of the common-law control test. This determination was often difficult. This new provision met the problem by deeming the crew leader to be the employer of the individual crew members. It was thought that this rule would ease the social security recordkeeping and reporting job of many farm operators.

10. Federal service (*sec. 3122*)

This section was aded by section 202(b) of the 1950 amendments. It prescribes special rules relative to payment of FICA taxes by Federal departments, agencies, and instrumentalities. The head of each Federal entity, or his agents, is made responsible for making the return and paying the employee's and employer's FICA taxes. However, for purposes of administrative convenience, he is authorized to ignore the $4,800 wage limitation and is not required to file claim for refund for any amount paid as tax on that part of remuneration above the $4,800 limitation.

11. Deduction as constructive payments (*sec. 3123*)

This provision, originally enacted in section 1101(c) of the Social Security Act, establishes the rule that amounts deducted from an employee's remuneration by an employer and paid to the United States, a State or political subdivision, shall be treated as income to the employee.

Chapter 22—Railroad Retirement Tax Act

SUBCHAPTER A. TAX ON EMPLOYEES

1. Rate of tax (*sec. 3201*)

The Railroad Retirement and Carriers Taxing Acts of 1937 are companion laws which replaced the Carriers Taxing Act of 1935. This earlier law had been declared unconstitutional because the benefit and taxing provisions were improperly interrelated in one act.

As originally enacted in the Carriers Taxing Act of 1937, the rate of tax was computed on "compensation earned," not in excess of $300 per month. Computation of the tax was changed to a "compensation paid" basis by section 3(a) of Public Law 572, applicable to services rendered after December 31, 1946. This change was made to avoid the heavy administrative burdens which arose because of the numerous corrections which had to be made in computations and reports previously filed. These corrections were necessary in cases of pay for time lost, retroactive wage increases, etc. This method for computing the tax remained in effect until enactment of the 1954 Code, which changed the method of computation back to a compensation earned basis.

The provision relating to further increases in the rate of tax was added by section 201(a) of Public Law 86–28 to provide for an increase in the Railroad Retirement Tax Act rate if there is an increase in the social security tax rate. The effect of this provision is to gear increases in the railroad retirement tax to an increase in the social security rate and thus avoid the need for further legislation respecting the railroad retirement tax rates.

2. Deduction of tax from compensation (*sec. 3202*)

As enacted in 1937 the rule for computation and deductions of tax when more than one employer is involved provided that the Commissioner of Internal Revenue may, by regulation, prescribe the proportion to be deducted by each employer. Public Law 572 (approved July 31, 1946) enacted the present proration rule, except for the dates and amount of compensation. The provision relating to compensation paid by a labor organization was added because it was found that employees of these organizations were reluctant to disclose to their railroad employers the precise amount of their income from labor organization activities, thereby making it impossible to prorate the compensation. To get around this administrative difficulty the special provision relating to compensation paid by a labor organization was added.

This section, as in the case of the FICA tax, makes the employer liable for the payment of the employee's tax and concurrent with this liability protects him against any claims and demands with respect to that part of the employee's compensation which he correctly withholds and pays to the Government.

SUBCHAPTER B. TAX ON EMPLOYEE REPRESENTATIVES

1. Rate of tax (*sec. 3211*)

The rate of tax on the employee representative is equal to the combined rates for the employee and employer under sections 3201 and 3221, respectively. The tax is an income tax and is computed the same as for an employee. Similarly, the provision for further rate increases avoids the need for additional legislation relative to the rate of tax by tying such increases to increases in the social security tax rate.

2. Determination of compensation (*sec. 3212*)

The provision of this section appeared in 1937. Its purpose was to prescribe the manner in which the employee representative tax is to be determined. Thus the organization for which the employee representative works is considered, for purposes of the tax, as though it were an employer, although the organization does not qualify as an "employer" under the statutory definition of that term.

SUBCHAPTER C. TAX ON EMPLOYERS

1. Rate of tax (*sec. 3221*)

The tax under this section is an excise tax on employers for the privilege of having employees. The proration provision relating to compensation paid by more than one employer, including a labor organization, was added by Public Law 572 with respect to services rendered after December 31, 1946.

Subsection 3221(b) was added by Public Law 86–28 and is similar to provisions of sections 3201 and 3211 with respect to further increases in the rate of tax.

SUBCHAPTER D. GENERAL PROVISIONS

1. Definition of employer (sec. 3231(a))

The Carriers Taxing Act of 1935 used the term "carrier" to describe those subject to that act. The term "employer" was substituted in the Carriers Taxing Act of 1937, which repealed the former act. The term "employer" was defined to include not only companies embraced within the term "carrier" but also railway labor organizations national in scope and organized under the Railway Labor Act. A company which is owned and controlled in common by several companies also came within the definition. Casual service and casual operation of equipment and facilities were excluded as was trucking service and electric street railways. Contractors, except those who perform casual service, were covered irrespective of whether control be legal or de facto. As a result, agreements, licenses, and other devices which insure that operation of the company is conducted in the interests of the carrier were considered to represent de facto control.

By broadening the concept of "employer" Congress sought to bring within the scope of the act substantially all organizations which are intimately related to the transportation of passengers or property by railroad in the United States.

The last sentence relating to the mining of coal was added by Public Act No. 764, 76th Congress, 1940, and represents a specific exclusion from the definition.

2. Definition of employee (sec. 3231(b))

The Carriers Taxing Act of 1937 defined this term to make it clear that any person in the service of an "employer" is to be considered an employee, regardless of where he performs his services. In addition, employees of local lodges or divisions of national labor organizations were not included as "employees" unless they were in the service of an employer on or after August 29, 1935.

In Public Law 572, 79th Congress, 2d session, clarifications were made in the definition respecting the "employment relationship." The changes were made for purposes of "eliminating inequities and facilitating administration." They related to the determination of employee status on and after August 29, 1935. Credit is given for service prior to enactment of the law if the individual was on that date either in active service or on leave of absence, or absent because of disability or sickness. Because of the low level of employment prior to 1935, there were substantial numbers of railroad workers on furlough whose rights either had expired or were not readily ascertainable as of August 29, 1935. Some furloughed individuals had not gone into other employment but had later returned to railroad work. On the other hand, a substantial number of other individuals whose furlough rights had not expired had not returned to railroad work. This latter group who had contributed nothing to the system were entitled, under the 1937 definition, to annuities based on prior service, while those who had returned to work were denied this privilege. Amendments in 1946 corrected this inequity by extending prior service credit to those who returned to work and served at least 6 months and to those who were unable to serve.

The last sentence of this subsection relating to coal mining is a companion provision to the last sentence of subsection 3231(a), both of which were added by Public Act No. 764, 76th Congress, 1940.

3. Definition of employee representative (sec. 3231(c))

This term was originally defined in the same subsection of the Carriers Taxing Act of 1935 which also defined employee. Congress found that this inclusion of "representative" and "employee" in a single class was artificial and caused confusion. The act of 1937 therefore provided for a separate definition of "employee representative" in a separate subsection.

4. Definition of service (sec. 3231(d))

The emphasis in the definition of the term "service" is placed upon the rendering of service for compensation rather than actual receipt of compensation. A person is "in service" and is an employee irrespective of where the service is rendered, except in the case of an employer not conducting the principal part of his business in the United States. A person is in "service" only when he is rendering service to such employer within the United States. Public Law 572, 79th Congress, broadened the definition to include professional or technical services when integrated into the staff of the employer or other services integrated into the employer's operations. The tests for determining whether an individual is in the service of a local lodge or division was added by Public Law 520, 77th Congress, 2d session.

5. Definition of compensation (sec. 3231(e))

The Carriers Taxing Act of 1937 changed the former definition of compensation to make it clear that the significance was the earning of compensation by the employee and not that it has been received by him. In addition, compensation received by the employee for time he was sick or on vacation is to be included in a computation of the employee's tax liability. Tips or the voluntary payment of the employee's tax were specifically excluded from the definition of compensation.

Section 3(f) of Public Law 572, 79th Congress, amended the definition by adding the provision which establishes a presumption that payments made through the regular payroll are compensation; it thus avoided the necessity for passing on a variety of items such as pay during periods of sickness, payments to the end of a pay period in which the employee dies, bonuses, etc. In addition, provision was made for crediting pay for time lost on account of personal injuries even though the pay is included in a general settlement. Prior to this change such payments had been held to be excluded from compensation.

The last sentence of paragraph (1) of this subsection was added by section 205 of Public Law 746, 83d Congress, to exclude from compensation certain payments to delegates to national or international conventions of railway labor organizations. This amendment avoided the nuisance of collecting trifling amounts in the case of delegates who have no other previous covered employment.

Chapter 23—Federal Unemployment Tax Act

1. Rate of tax (sec. 3301)

The taxing provisions of title IX of the Social Security Act were included in chapter 9 of the 1939 Code, and became known as the Federal Unemployment Tax Act by virtue of the 1939 amendments.

As originally enacted in the Social Security Act, the tax rates were applied to "wages payable," as was also true in the case of the FICA tax. The 1939 amendments, for reasons of administrative simplicity, provided that the rates were to be applied to "wages paid." Thus the date of payment rather than the date of performance of services is controlling, thereby simplifying recordkeeping by the employers. The 1939 amendments provided for continuance of the 3-percent rate which has not been changed since then.

2. Credits against tax (sec. 3302)

The provision for credit against the unemployment tax was enacted in the original Social Security Act. The primary purpose of the credit was to encourage the States to adopt unemployment insurance laws, which they had been reluctant to do because they felt this action would handicap their industries in competition with the industries of other States. The credit provision was modeled after the provisions of the Federal estate tax law under which credit is allowed for amounts paid under State inheritance laws. The Senate Finance Committee in its report on the social security bill stated that "with a uniform tax and this offset device, employers in all States will be put in an equal competitive position."

As originally enacted, the credit was limited to contributions paid by the employer with respect to "employment" as then defined. This rule excluded contributions under a State law with respect to services not covered by the definition. Section 608 of the 1939 amendments eliminated the reference to "employment."

The provision of section 3302(a)(4) relating to erroneous payments was enacted by the 1939 amendments as a relief measure for those employers who mistakenly made payments under the wrong unemployment compensation law.

To encourage employers to stabilize their employment an additional credit was granted, whereby "the Federal Government shall recognize credits in the form of lower contributions rates granted by States." The provision for additional credit was added by the Senate Finance Committee. Under the committee amendment the taxpayer can, under certain conditions, credit the amount by which his contributions are less than they would have been if he had been contributing at the maximum rate in the State, not in excess of 2.7 percent. The 1939 amendments extended the additional credit to contributions for service under a State law although such service was not covered under the Federal law.

The 90 percent limit on total credits was originally included in sections 902 and 909(c) of the Social Security Act. The 10 percent difference was payable to the Federal Government to defray administrative costs of the unemployment insurance program. The provisions for reducing the amount of the additional credit, if advances to State unemployment funds are not repaid, was enacted by Public Law 567, act of August 5, 1954.

3. Conditions of additional credit allowance (*sec. 3303*)

The conditions specified in this section were enacted in the Social Security Act to insure that the additional credit was not given until the compensation experience of the employer justified a reduced contribution rate. Thus, for example, the employer contributing to a pooled fund must have had 3 years' experience before the reduced rate is effective. However, section 2 of Public Law 767, the act of September 1, 1954, added the last paragraph to this section to provide that, effective January 1, 1955, additional credit would be allowed to employers who had 1 or 2 years' experience under a State law. The new rule was adopted to permit the States to extend tax reductions to new and newly covered employers, who had not had 3 years' experience.

As a means for insuring compliance with the requirements relating to State standards, the 1939 amendments required the Social Security Board (later the Department of Labor) to certify that the State laws comply with the requirements of this section. In the absence of such certification, the additional credit is not permitted. The terms "having individuals in their employ," "services," and "remuneration" were first used in the 1939 amendments and replaced the terms "employer," "services," and "wages" which had special meanings because of definitions adopted. The purpose for such change was to make the requirements of the section more easily applied to the different State laws, thereby avoiding a disqualification of a State law because of differences between the coverage of such State law and the coverage under the Federal law.

4. Approval of State laws (*sec. 3304*)

This section is designed to insure that State laws meet certain minimum standards and are "genuine unemployment compensation acts and not merely relief measures." The provision first appeared in section 903(a) of the Social Security Act and has undergone minor revisions since then. Approval of the State law is a condition precedent to granting funds to States for the administration of their employment security laws, as well as to permitting the normal and additional tax credits to employers.

5. Applicability of State law (*sec. 3305*)

The provisions of the separate subsections represent a grant of authority to the States authorizing them to require the designated categories to comply with State unemployment compensation laws. The provisions of subsection (a) were enacted in section 906 of the Social Security Act. The 1939 amendments clarified the provision to make clear that an employer engaged in foreign commerce, as well as one engaged in interstate commerce, is subject to the authority of a State law requiring payments into an unemployment fund. Subsections (b), (c), and (d) were added by the 1939 amendments. Subsection (f), relating to maintenance workers, was added by the 1946 amendments, while subsections (g), (h), and (i), relating to service performed by seamen on certain vessels operated by the United States, were added by Public Law 196, 83d Congress, approved August 5, 1953.

6. Definition of employer (*sec. 3306*(*a*))

This term is not defined under the FICA provisions. As originally defined in section 907 of the Social Security Act, the term did not include any person unless he had eight or more individuals "in his employ" on each of some 20 days during the taxable year, each day being in a different calendar week. The 1939 amendments modified the definition by adding "in employment"; this had the effect of restricting the definition to persons who employed individuals who performed services "in employment," as later defined.

The definition was amended by section 1 of Public Law 676 (H.R. 9709), act of September 1, 1954, by substituting "four or more" for "eight or more." The effect of this amendment was to extend the application of the Federal unemployment tax with respect to services performed after December 31, 1955.

7. Definition of wages (*sec. 3306*(*b*))

The definition of wages for purposes of the unemployment tax is more restrictive than for the FICA tax. For example, under FICA the taxable wage limitation is $4,800 while under FUTA it is $3,000. Beginning with 1951 the provisions relating to remuneration for service as a domestic, a farmworker, and a homeworker appear in the definition of wages under FICA but not under FUTA. This is because the 1950 amendments had extended the coverage under FICA to these workers but did not make a similar change with respect to the unemployment tax. One other distinction relates to remuneration earned by "standby" employees who have reached retirement age. The age limit is 65 for both men and women under the unemployment act, whereas it was reduced by the 1956 amendment to age 62 for women under FICA.

Except for the foregoing differences, the definitions of wages under FICA and FUTA are similar and have undergone the same modifications and changes. Thus, for example, the rule respecting remuneration paid by a successor when the employee had also worked for the predecessor was made applicable under both FICA and FUTA by the 1950 amendments.

8. Definition of employment (*sec. 3306*(*c*))

The definition of employment in titles VIII and IX of the original Social Security Act differed with respect to the types of service falling under the "exceptions." Thus, under title VIII casual labor not in the course of the employer's trade or business as well as service at age 65 and over were excepted, while under title IX family employment was excepted. Other exceptions under both titles were similar.

The 1939 amendments extended the definition under FICA to include, under certain conditions, service outside the United States on an American vessel. The definition under FUTA did not contain this extension. Service as an insurance salesman on a commission basis was excluded under FUTA while services in certain fishing activities were excluded under the FICA provisions. Otherwise, the definitions of employment under FICA and FUTA were identical.

The 1946 amendments modified the definition under FUTA to include service, under certain conditions, outside the United States if performed on an American vessel. The purpose for this amendment was to extend coverage under the unemployment compensation provisions to maritime workers. Through this amendment Congress sought to encourage the maintenance of an adequate merchant marine. Also amended was the exception relating to service on the navigable waters of the United States. The amended exception excludes service on a non-American vessel if the service is performed both within and outside the United States. Another amendment in 1946 added paragraph (17), relating to certain fishing activities, to the list of exceptions.

While the 1950 amendments extended FICA coverage to many additional groups, the same coverage was not extended under the unemployment provisions. This had the effect of narrowing the definition of employment under FUTA as compared with FICA. Thus, for example, service as a farmworker or domestic worker continued to be excluded from the unemployment tax. Casual labor, service for exempt organizations, and certain services by students were the main classes of work affected by the 1950 amendments insofar as the unemployment tax is concerned.

9. Included and excluded service (*sec. 3306*(*d*))

The 50-percent rule here is similar to the provisions relating to included and excluded service under the FICA provisions. This is a rule of administrative convenience.

10. Unemployment fund (*sec. 3306*(*f*))

The 1939 amendments added the second and third sentences to the definition. The second sentence removes any doubt that moneys withdrawn from the trust fund by a State but unexpended shall remain a part of the State fund. The reason for the third sentence was to make clear that an employer is entitled to credit against the Federal tax only so long as the State uses its funds for a proper purpose. The 1946 amendments added the first exception to provide for the withdrawal from the trust fund for payment of disability benefits of any payments which the States collect from employees and deposit in the trust fund. The second exception was added in 1954 to permit the use of credited funds for administrative purposes.

11. Definition of contributions (*sec. 3306*(*g*))

As originally set forth in section 907 of the Social Security Act, contributions were defined in terms of "employer" and "wages." To avoid this restrictive definition the 1939 amendments redefined contributions in more general terms; the effect was to include payments required by a State law with respect to services not covered by the Federal law.

12. Definition of employee (*sec. 3306*(*i*))

As originally defined in section 1101(a)(6) of the Social Security Act, the term "employee" included an officer of a corporation. The present definition was adopted June 14, 1948, by Public Law 642, 80th Congress, which was passed over a veto. The amended definition had the same effect as if included in the Internal Revenue Code on February 10, 1939, the date of the code's enactment.

The definition of this term has been one of the most controversial in the employment tax field. The term had been subject to varying interpretations, both administratively and judicially. In 1947, the Supreme Court in a series of cases laid down a number of "tests" for determining who is an employee. The definition adopted by Congress in 1948 made the "tests" inoperative by providing for the application of the usual common-law rules in determining who is an employee for both the FICA and the FUTA taxes. The 1948 definition has continued to the present time with respect to the unemployment tax, but was modified by the 1950 amendments to include additional categories for purposes of the FICA tax.

13. Definition of agricultural labor (*sec. 3306*(*k*))

This definition is the one adopted by the Social Security Act Amendments of 1939 for both FICA and FUTA. The purpose of the definition was to exclude from coverage certain fringe activities not then specifically exempted. Although the 1950 amendments removed certain activities from the definition for old-age and survivors insurance purposes, the definition for unemployment tax purposes was unchanged.

14. Vessels operated by general agents of the United States (*sec. 3306*(*n*))

The purpose of this section was to render inapplicable the exception from "employment" relating to service in the employ of the United States or instrumentality (sec. 3306(c)(7)), if the service is performed by a seaman on certain vessels operated by the United States. For purposes of the unemployment tax, service performed by a seaman for a general agent of the Secretary of Commerce is deemed to be performed for such general agent rather than for the United States, if the vessel is owned by or is under bareboat charter to the United States.

Chapter 24—Collection of Income Tax at Source on Wages

1. Definition of wages (*sec. 3401*(*a*))

This definition, in conjunction with the definitions of employer and employee, determines "coverage" for withholding purposes. It will be noted there are some similarities between the coverage under this chapter and under chapters 21 and 23. At the same time there are several major differences which are reflected in the enumerated exceptions. For instance, there is no ceiling on the amount of remuneration which constitutes wages for withholding tax purposes, while under chapters 21 and 23 remuneration in excess of a specified amount is not considered to be "wages." The differences in the definitions represent the separate purposes to be achieved under the respective "employment" chapters.

This definition first appeared in section 465(b) of the 1939 Code which was added by section 172 of the Revenue Act of 1942. For victory tax purposes, remuneration for military service, agricultural labor, domestic service, casual labor, service for a foreign government or instrumentality, or services performed outside the United States was exempted. The Current Tax Payment Act of 1943, which expanded the withholding system of the victory tax to cover the regular income tax, modified the "wages" definition by elimination of one exception and the addition of others.

Remuneration for service as an employee of a nonresident alien was no longer listed as an exception. Congress found that, although such employers are not engaged in trade or business in the United States, they often do have in this country an office or agents by whom wages are paid to residents or citizens in the United States. The 1943 act added paragraphs 6(A) and 7 relating to remuneration for services performed by nonresident aliens. The provisions of these paragraphs relative to residents of contiguous countries who enter and leave the United States at frequent intervals were included in order to extend withholding to such nonresidents with certain exceptions to be determined by regulations. Clause (B) of paragraph (6) was subsequently added by section 221 of the Revenue Act of 1950.

The provision relative to service outside the United States was modified to make clear that such service on an American vessel did not come within the purview of the exception. This change conformed administrative practice regarding such services. The 1943 act also added the provision excluding remuneration for services as a minister of the gospel.

With reference to paragraph (1), section 10(a) of Public Law 384, 80th Congress, August 8, 1947, struck the provision which excluded remuneration for service in the military forces from the list of exceptions. The exception was restored by section 305(a) of the act of October 20, 1951. The apparent purpose here was to exempt combat pay from the withholding provisions.

Section 10(a) of Public Law 384 also amended paragraph 8 to limit its application (1) to remuneration for services for an employer (other than the United States or any agency thereof) performed by a citizen of the United States if it is reasonable to believe that during the entire calendar year the employee will be a bona fide resident of a foreign country, and (2) to remuneration for services performed within a possession of the United States if above a specified amount. Section 321(b) of the act of October 20, 1951, further amended this paragraph to provide that withholding would not be required where it is reasonable to believe the employee will qualify for exclusion on the basis of presence in a foreign country for 17 out of 18 consecutive months. The purpose of these changes in paragraph (8) was to make withholding more closely in harmony with provisions of the code relating to earned income from sources outside the United States and income from sources within the possessions of the United States.

The Social Security Act Amendments of 1950 made several modifications and additions to the exceptions under the "wages" definition for withholding purposes. Thus, the exception in paragraph (4), pertaining to casual labor, was made more restrictive by providing "earnings" and "days worked" tests. Paragraph (9) was enlarged to include service as a member of a religious order, while paragraphs (10), (11), and (12) were added to the list of exceptions for the first time. In general the changes made by the 1950 amendments were primarily for the purpose of conforming the definition under the withholding provisions with the related provisions under FICA.

The provisions in paragraph (8) relating to Puerto Rico were added by section 221(f) of the Revenue Act of 1950. Since the enactment of the 1954 Code the words "possession of the United States" were added to subparagraph (8)(ii) by Public Law 321, August 9, 1955. Otherwise, the definition has remained substantially unchanged.

2. Definition of payroll period (*sec. 3401*(*b*))

As originally enacted in section 465(a) of the Revenue Act of 1942, this term was defined to mean a period for which a payment of wages is ordinarily made to the employee by his employer. Section 2 of the Current Tax Payment Act of 1943 added the concept of "miscellaneous payroll period," which was defined to mean any period other than a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, or annual payroll period. Thus, if the employer's ordinary practice is to pay his employees for periods of 10 days, such 10-day periods are miscellaneous payroll periods.

3. Definition of employee (*sec. 3401*(*c*))

This definition has remained unchanged since its enactment in section 465(d) of the Revenue Act of 1942. In its consideration of this problem in 1942, the Senate proposed a definition which would include, in addition to public officers, Government employees, and elected officials, certain individuals who are not employees under the law of master and servant. The effect of the Senate amendment was to broaden the common-law concept and to bring within the purview of the withholding provisions certain individuals who would not otherwise be covered. This amendment was rejected in conference. However, public officers, employees, and elected officials of the United States, a State, the District of Columbia, and a territory or any political subdivision were specifically included in the definition. As in the case of the FICA and FUTA, the term was also defined to include an officer of a corporation.

4. Definition of employer (*sec. 3401*(*d*))

As adopted in 1942 this definition did not contain the two numbered exceptions. In addition to the definition of "employer," the Revenue Act of 1942 contained a definition of "withholding agent." Section 2 of the Current Tax Payment Act of 1943 eliminated the definition of "withholding agent" and broadened the definition of "employer" to include, in addition to the persons for whom services are performed, (1) persons making payment of wages in situations where the wage payments are not under the control of the person for whom services are performed and (2) persons paying wages for services performed for another. It was found that the general definition was not adequate to cover certain special situations such as the case where the local agent of a nonresident alien individual, a foreign partnership, or a foreign corporation pays wages to a citizen or resident of the United States, and the case of certain types of pension payments. The two numbered exceptions were adopted to deal with these special situations; they were not intended as a departure from the basic purpose of centralizing responsibility for withholding.

5. Definition of number of withholding exemptions claimed (*sec. 3401*(*e*))

As enacted in 1943, the number of withholding exemptions was determined by reference to (1) the status of the individual employee as single, married, etc., (2) the number of his dependents, and (3) in the case of a married person whose spouse was also employed, the amount of the withholding exemption claimed by each spouse. This information was to be determined by the employer on the basis of information furnished by the employee. Thus, definitions were included for such terms as "single person," "married person," "head of family," etc., in order that the employer could determine the number of the employee's withholding exemptions.

The Individual Income Tax Act of 1944 amended the code to provide for "per capita" exemptions. This simplification made possible a change in the crediting of exemptions for withholding purposes and eliminated the need for continuing the definition relative to "status." In lieu thereof, the present subsection was inserted to define the "number of withholding exemptions claimed" for the purpose of new withholding tables provided by the 1944 act. This term appears in the heading of the tables and is defined as the number of withholding exemptions claimed by the employee in the withholding exemption certificate in effect at the time of the withholding.

6. Income tax collected at source—requirement of withholding (sec. 3402(a))

This requirement is similar to the one enacted in 1942 with respect to withholding of the victory tax. At that time the excess of wages paid over the "withholding deduction" represented the amount subject to the 5 percent victory tax withholding rate. The Current Tax Payment Act of 1943 provided for withholding a tax equal to the greater of (1) 20 percent of wages in excess of the allowable "withholding exemption" or (2) 3 percent of wages in excess of the "victory tax withholding exemption."

The Individual Income Tax Act of 1944 modified the withholding requirement so as to withhold approximately the full income tax liability on wages up to $5,000. To do this, section 22(a) of the act provided for graduated withholding through the second surtax bracket. Thus, withholding was computed at 2.7 percent for the normal tax, at 18 percent for incomes in the first surtax bracket, and at 19.8 percent for incomes above the first bracket.

The Revenue Act of 1945 established the same exemptions for the normal tax as for the surtax and thus simplified the calculation of the withholding tax by eliminating the 2.7 percent rate.

The Revenue Act of 1948 provided split income treatment for married taxpayers. To avoid further complications which this provision would have introduced in the withholding system, the withholding requirements were changed to provide for a single withholding rate. Except for changes in the withholding rate, necessitated by changes in the applicable tax rate, the withholding requirements have, with minor exceptions, remained unchanged since then.

7. The percentage method of withholding (sec. 3402(b))

The percentage method for computing the amount to be withheld requires an actual computation; this takes into consideration the amount of wages in the payroll period, the number of withholding exemptions, the amount of each withholding exemption for the period, and the percentage rate of withholding. The amount of the withholding exemption applicable to all wage payments is determined under the schedule provided in this subsection; the rules relative to the application of such schedule are provided in paragraphs (2) through (5).

The basic rules of this subsection were enacted in the Current Tax Payment Act of 1943 and have remained unchanged since then. The schedule reflecting the amount of an exemption has been changed as required to reflect changes made elsewhere in the code. Thus, the elimination of withholding at the second surtax rate and the adoption of per capita exemptions has made possible a simplification of the schedule. It should be noted that the amount of a withholding exemption takes into account not only the per capita exemption but also the allowable 10-percent standard deduction. For example, the annual withholding exemption is $667 rather than the $600 per capita exemption alone.

8. Wage bracket withholding (*sec. 3402*(*c*))

In lieu of computing the actual amount to be withheld, the employer may use the appropriate withholding table as set out in this subsection. In the construction of these tables, the amount to be withheld has been computed at the midpoint of the wage bracket. This feature of the withholding table results in minor under- or over-withholding in those instances where the wage amount is above or below the midpoint of the bracket.

The withholding tables included in the Current Tax Payment Act of 1943 were complicated by the need to give effect to the various exemption amounts in effect at that time. The adoption of the uniform per capita exemptions in the Individual Income Tax Act of 1944 make possible a simplification of the withholding tables.

The rules in paragraphs (2) through (5) relating to the application of the withholding tables were enacted in 1943 and have remained unchanged since then.

9. Tax paid by recipient (*sec. 3402*(*d*))

Under the provisions of this subsection, enacted in 1943, payment by the recipient of the income of the tax required to be withheld by the employer relieves the employer from payment of the tax but does not relieve him from liability for additions to the tax or penalties for failure to withhold.

10. Included and excluded service (*sec. 3402*(*e*))

If the remuneration paid for services performed during one-half or more of any payroll period constitutes wages, all the remuneration paid for such period is deemed to be wages. This 50-percent rule was adopted in order to avoid unnecessary administrative problems. The subsection was originally adopted in 1943. It has application only to remuneration paid for a period of not more than 31 consecutive days which constitutes an established payroll period. It has no application to remuneration paid at irregular intervals or to remuneration paid without regard to any period. It is intended to minimize changes in pay periods in order to avoid withholding.

11. Withholding exemptions (*sec. 3402*(*f*))

In general, the employee may claim for withholding purposes the same exemptions to which he is entitled upon filing his tax return. The amount of the withholding exemption is $667, as compared with the regular exemption of $600; it thus takes into account the 10-percent standard deduction.

The purpose of the withholding certificate is to enable the employer to determine the amount of withholding exemption applicable to the wages of each employee or, if the employer elects to adopt wage bracket withholding, the amount to select from the tables. Once in effect the withholding certificate remains in effect until another one is furnished by the employee. A reduction in the employee's exemptions requires a change in his certificate. This certificate showing the change in status takes effect with respect to the first payment of wages made on or after the first status determination date, which falls on January 1 and July 1. The purpose for this rule is to allow the employers ample time to adjust payroll and other accounting records.

The general provisions of this subsection were included in the Current Tax Payment Act of 1943. Additional details relating to the filing of certificates, change in exemption status, effective date of certificate, status determination date, etc., were added by the Individual Income Tax Act of 1944. Changes in the subsection since then conform with changes which modified provisions relating to exemption credits in computing tax liability.

12. Overlapping pay periods and payment by agent or fiduciary (*Sec. 3402(g)*)

This provision was enacted in its present form by section 2 of the Current Tax Payment Act of 1943. Its purpose was to provide for handling wage payments which did not fall within the statutory pattern of periodic payments. Thus, withholding on bonuses, commissions, dismissal wages, etc., made in addition to periodic wage payments, and payments overlapping calendar years was subject to procedures prescribed by regulations. The provision respecting overlapping payments is to limit the withholding exemption allowed to an employee, who receives supplementary wages in any calendar year, to an amount approximating the withholding exemption for an annual payroll period.

Withholding in the case of wage payments overlapping calendar years is, under the percentage method, determined as if such payroll period constituted an annual payroll period. Under the wage bracket method the amount to be withheld is determined as though the payroll period constituted a miscellaneous payroll period of 365 days.

Paragraph (4) relates to the problem that arises when the employee works for an organization or agency which performs a phase of work for several employers, all of whom contribute to the payment of the employee's wages.

13. Withholding on basis of average wages (*sec. 3402(h)*)

This provision was enacted in 1943 to promote the efficient functioning of the withholding system in cases where there is steady employment and little fluctuation in wages between pay periods.

14. Additional withholding (*sec. 3402(i)*)

This provision was added by section 203 of the Revenue Act of 1951 to deal with those instances where the withholding system fails to withhold amounts equal to final tax liability arising from the fact that withholding is limited to a single rate. Since it was not feasible to establish a system of general application because of such factors as variations in deductions, etc., this provision permits individual employees to enter into agreements with their employers for the withholding of amounts over and above that withheld through the regular operation of the withholding system.

15. Noncash remuneration to retail commission salesman (sec. 3402(j))

This provision was added by Public Law 306, August 9, 1955. Its purpose is to exempt from the withholding requirements remuneration in the form of prizes offered retail commission salesmen who exceed sales quotas, etc. Although withholding is not required, the employer must include the fair market value of such prizes on the W–2 form given to the salesman. This is a permissive provision and the employer may, at his election, withhold on the noncash remuneration.

16. Liability for the tax (sec. 3403)

This provision is similar to those respecting the FICA and railroad retirement taxes, in that the employer is made liable for payment of the tax which the law requires to be withheld. The provision has remained unchanged since its enactment in 1943.

Chapter 25—General Provisions Relating to Employment Taxes

1. Acts to be performed by agents (sec. 3504)

This provision was added in conference to the Current Tax Payment Act of 1943. Its purpose is to clarify the responsibilities for withholding of tax when an employee works for an agent of several employers. The provision authorizes the Secretary or his delegate to designate such agent to perform the acts required of an employer. If the designation is made, all provisions of law (including penalties) applicable to an employer are made applicable to the fiduciary, agent, or other person so designated. However, such designation does not relieve the employer, for whom the agent acts, from the provisions of law applicable in respect of employers.

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